

chair **Betty T. Yee**
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STATE OF CALIFORNIA
Franchise Tax Board

Preliminary Summary of Federal Income Tax Changes
2017 – First Release

Laws Affected

Personal Income Tax Law

Corporation Tax Law

Administration of Franchise and Income Tax Laws

Preliminary Summary of Federal Income Tax Changes
2017 – First Release

Prepared by the Staff of the
Franchise Tax Board
STATE OF CALIFORNIA

Members of the Board:
Betty T. Yee, Chair
George Runner, Member
Michael Cohen, Member

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This report is submitted in fulfillment of the requirement in Revenue and Taxation
Code section 19522.

Preliminary Summary of Federal Income Tax Changes – 2017

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EXECUTIVE SUMMARY

Prepared by the Staff of the
Franchise Tax Board (FTB)
State of California

During 2017, the Internal Revenue Code (IRC) or its application by California was changed by:

PUBLIC LAW	TITLE	DATE
115-63	Disaster Tax Relief and Airport and Airway Extension Act of 2017	September 29, 2017
115-97	An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act) Title I, Subtitle C, Parts V-IX	December 22, 2017

Preliminary Summary of Federal Income Tax Changes – 2017

This preliminary report explains portions of the new 2017 federal laws along with the effective dates, the corresponding California law, if any, including an explanation of any changes made in response to the new federal law, and the impact on California revenue if California were to conform to applicable federal changes.

This report also contains citations to the section numbers of federal Public Laws, the IRC, and the California Revenue and Taxation Code (R&TC) impacted by the federal changes.

Disaster Tax Relief and Airport and Airway Extension Act of 2017
Public Law 115-63, September 29, 2017

TITLE V—TAX RELIEF FOR HURRICANES HARVEY, IRMA, AND MARIA

<u>Section</u>	<u>Section Title</u>
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501	Definitions
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Background

Present law provides a variety of tax relief provisions for victims of the hurricanes that hit the Gulf region in 2005.¹ These provisions include suspending certain limitations on deductions for personal casualty losses;² extending the replacement period for nonrecognition of gain,³ providing an employee retention credit for affected employers; allowing additional first-year depreciation for certain property; increasing the amount that may be expensed;⁴ allowing certain demolition and clean-up costs to be expensed; altering the carryback period for net operating losses that result from public utility property disaster losses; extending the carryback period for net operating losses; liberalizing the representation requirements for owners of residential real property financed by private activity bonds; providing tax beneficial rules for distributions to disaster victims from qualified retirement plans; and, allowing certain retirement plan amendments made in light of the disaster to be retroactive.

New Federal Law (Uncodified Act section 501)

The uncodified provision defines a net disaster loss as the excess of qualified disaster-related personal casualty losses over personal casualty gains. Qualified disaster-related personal casualty losses are losses which arise:

- In the Hurricane Harvey disaster area on or after August 23, 2017, and which are attributable to Hurricane Harvey;
- In the Hurricane Irma disaster area on or after September 4, 2017, and which are attributable to Hurricane Irma; or
- In the Hurricane Maria disaster area on or after September 16, 2017, and which are attributable to Hurricane Maria.

A disaster “zone” means the portion of the disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act⁵ by reason of the disaster. A disaster “area” means an area with respect to which a major disaster has been declared by the President by reason of the disaster.

¹ Public Law 109-73, Katrina Emergency Tax Relief Act of 2005 (KETRA), and Public Law 109-35, Gulf Opportunity Zone Act of 2005 (GO Zone Act). IRC sections 14000, 1400P, 1400Q, 1400R, 1400S and 1400T.

² IRC section 165.

³ IRC section 1033.

⁴ IRC section 179.

⁵ Public Law 100-707.

Effective Dates

This provision is effective upon enactment (September 29, 2017) for losses arising in the Hurricane Harvey disaster area on or after August 23, 2017, the Hurricane Irma disaster area on or after September 4, 2017, and Hurricane Maria disaster area on or after September 16, 2017.

California Law (None)

California does not conform to the uncodified federal act provisions.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
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502	Special Disaster-Related Rules for Use of Retirement Funds.
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Background

A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless, among other things: (1) the loan amount doesn't exceed the lesser of \$50,000, or half of the present value of the employee's nonforfeitable accrued benefit under the plan (however, a loan up to \$10,000 is allowed, even if it exceeds half the employee's accrued benefit);⁶ and (2) the loan is required to be repaid within five years,⁷ except that a longer repayment period can be used for a principal residence plan loan.⁸

Early withdrawals, generally pre-age 59 ½, from a qualified retirement plan result in regular taxable income plus an additional tax applies equal to 10 percent of the amounts withdrawn that are includible in gross income.⁹ The additional tax applies unless the taxpayer qualifies for one of several specific exceptions.¹⁰

New Federal Law (Uncodified Act section 503 affecting IRC sections 72, 402, 408, and 3405)

This provision eases a number of rules to allow victims to make qualified hurricane distributions (QHD) from their retirement plans of up to \$100,000, less any prior withdrawals treated as QHDs. It also excepts QHDs from the 10-percent additional tax for early withdrawals and allows taxpayers to spread out any income inclusion resulting from such withdrawals over a 3-year period, beginning with the year that any amount is required to be included.

⁶ IRC section 72(p)(2)(A).

⁷ IRC section 72(p)(2)(B)(i).

⁸ IRC section 72(p)(2)(B)(ii).

⁹ IRC section 72(t)(1).

¹⁰ IRC sections 72(t)(2) and 72(t)(3).

A QHD is defined as any distribution from an eligible retirement plan,¹¹ including individual retirement accounts (IRAs), made:

- On or after August 23, 2017, and before January 1, 2019, to an individual whose principal place of abode on August 23, 2017, is located in the Hurricane Harvey disaster area and who has sustained an economic loss by reason of Hurricane Harvey;
- On or after September 4, 2017, and before January 1, 2019, to an individual whose principal place of abode on September 4, 2017, is located in the Hurricane Irma disaster area and who has sustained an economic loss by reason of Hurricane Irma; and
- On or after September 16, 2017, and before January 1, 2019, to an individual whose principal place of abode on September 16, 2017, is located in the Hurricane Maria disaster area and who has sustained an economic loss by reason of Hurricane Maria.

The provision also allows the amount distributed to be re-contributed at any time over a 3-year period beginning on the day after the distribution was received. If the amount is re-contributed to an eligible retirement plan other than an IRA, the taxpayer is treated as having received the QHD in an eligible rollover distribution¹² and as having transferred the amount to an eligible retirement plan in a direct, trustee-to-trustee transfer within 60 days of the distribution. If the amount is re-contributed to an IRA, the QHD is treated as a distribution¹³ that is transferred to an eligible retirement plan in a direct trustee to trustee distribution within 60 days of the distribution.

QHDs aren't treated as eligible rollover distributions for purposes of the 20-percent withholding requirement.¹⁴

The provision also allows for the re-contribution of certain retirement plan withdrawals for home purchases or construction, which were received after February 28, 2017, and before September 21, 2017, where the home purchase or construction was cancelled on account of Hurricanes Harvey, Irma, or Maria. A timely re-contribution avoids tax on the plan withdrawal if made during the period beginning on August 23, 2017, and ending on February 28, 2018.

With respect to retirement plan loans, the provision:

- Increases the maximum amount that a participant or beneficiary can borrow from a qualified employer plan,¹⁵ from \$50,000 to \$100,000,
- Removes the one half of present value limitation, and
- Allows for a longer repayment term, if the due date for any repayment with respect to the loan occurs during a qualified beginning date that is Hurricane-specific and ends on December 31, 2018, by delaying the due date of the first repayment by one year and adjusting the due dates of subsequent repayments accordingly.

¹¹ IRC section 402(c)(8)(B).

¹² IRC section 402(c)(4).

¹³ IRC section 408(d)(3).

¹⁴ IRC section 3405(c)(1)(B).

¹⁵ IRC section 72(p)(2)(A).

Effective Date

This provision is effective as of the date of enactment, September 29, 2017.

California Law (R&TC sections 17024.5, 17081, 17085, 17085.7, and 17501)

Except for the federal changes applicable to retirement plan loans, California automatically conforms to the federal changes with respect to QHDs from and re-contributions to a hurricane victim's retirement plan¹⁶. Under the Personal Income Tax Law (PITL), California generally conforms to retirement plan loan rules as of the "specified date" of January 1, 2015,¹⁷ and as a result, does not conform to the modifications made by this loan provision.

California withholding on eligible rollover distributions is 10 percent of the federal withholding amount.¹⁸ However, because under this provision the federal 20-percent withholding is not applicable to QHDs that are eligible rollover distributions, California withholding does not apply.

California also automatically conforms to any federal changes made to the additional tax on early distributions from qualified retirement plans, modified to provide that the California early-distribution tax is 2.5 percent of the amount includible in income rather than the federal rate of 10 percent.

Impact on California Revenue

Baseline.

¹⁶ Under R&TC section 17501, California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, including Part I (IRC sections 401 to 420, relating to pension, profit-sharing, stock bonus plans, etc.), as of R&TC section 17024.5's "specified date" of January 1, 2015. However, except for increases in the maximum amount of elective deferrals that may be excluded from income under IRC section 402(g), R&TC section 17501(b) specifically provides that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes (and thus California adopts all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5).

¹⁷ R&TC section 17081 conforms to IRC section 72(p), relating to loans treated as distributions, as of the "specified date" of January 1, 2015, contained in R&TC section 17024.5.

¹⁸ Unemployment Insurance Code (UIC) section 13028(c)(3).

<u>Section</u>	<u>Section Title</u>
503	Disaster-Related Employment Relief

Background

The general business credit (GBC) is a limited nonrefundable credit against income tax that is claimed after all other nonrefundable credits. The GBC includes many credits, including the investment credit, work opportunity credit, alcohol fuels credit, enhanced oil recovery credit, renewable electricity production credit, and marginal oil and gas well production credit. A GBC is allowed against income tax for a particular taxable year and equals the sum of GBC carryforwards to the taxable year, the current year GBC, and GBC carrybacks to the taxable year.¹⁹

New Federal Law (Uncodified Act section 503 affecting IRC sections 38 and 51)

The provision creates a new “employee retention credit” for eligible employers affected by Hurricanes Harvey, Irma, and Maria. Eligible employers are generally defined as employers that conducted an active trade or business in a disaster zone as of the specified dates of August 23, 2017, for Hurricane Harvey, September 4, 2017, for Hurricane Irma, and September 16, 2017, for Hurricane Maria, and the active trade or business was, on any day between the specified date and January 1, 2018, rendered inoperable as a result of damage sustained by the hurricane.

In general, the credit is treated as a GBC, and is equal to 40 percent of up to \$6,000 of qualified wages with respect to each eligible employee of such employer for the taxable year.

Qualified wages means wages²⁰ paid or incurred by an eligible employer with respect to an eligible employee on any day after the specified date and before January 1, 2018, that occurs during the period beginning on the date on which the employer's trade or business first became inoperable at the principal place of employment of the employee immediately before the respective hurricane, and ending on the date on which such trade or business has resumed significant operations at such principal place of employment.

Qualified wages includes wages paid without regard to whether the employee performs no services, performs services at a different place of employment than the principal place of employment, or performs services at the principal place of employment before significant operations have resumed. An employee cannot be taken into account more than one time for purposes of the employee retention tax credit. So, for example, if an employee is an eligible employee of an employer with respect to Hurricane Harvey for purposes of the credit, the employee cannot also be an eligible employee of the employer with respect to Hurricane Irma or Hurricane Maria.

¹⁹ IRC section 38(a). Also, IRC section 38(b) contains a list of the component credits of the current year business credit.

²⁰ As defined in IRC section 51(c)(1) but without regard to IRC section 3306(b)(2)(B).

Disaster Tax Relief and Airport and Airway Extension Act of 2017
Public Law 115-63, September 29, 2017

The provision also provides that rules²¹ similar to those disallowing the work opportunity tax credit (WOTC) when the employee is considered related to the employer, and rules similar to those that apportion the WOTC among commonly-controlled businesses, shall apply.²²

Effective Date

The provision is effective for wages paid or incurred after August 23, 2017, for Hurricane Harvey, September 4, 2017, for Hurricane Irma, and September 16, 2017, for Hurricane Maria through January 1, 2018.

California Law (None)

California does not conform to the new federal employee retention credit or to existing federal GBC provisions.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
504	Additional Disaster-Related Tax Relief Provisions

Background

Charitable Contribution Deduction

An individual who itemizes can deduct charitable contributions up to 50 percent, 30 percent, or 20 percent of adjusted gross income (AGI), depending on the type of property contributed and the type of donee.²³ A corporation generally can deduct charitable contributions up to 10 percent of its taxable income.²⁴ Amounts that exceed the ceilings, referred to as excess contributions, can be carried forward for five years by both individuals and corporations, subject to various limitations and ordering rules.²⁵ For individuals, charitable contributions are deductible only as an itemized deduction.²⁶

²¹ IRC section 51(i)(1).

²² IRC section 52.

²³ IRC section 170(b)(1).

²⁴ IRC section 170(b)(2).

²⁵ IRC section 170(d).

²⁶ Treasury Regulation section 1.170A-1(a).

Casualty Losses

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.²⁷ For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses for the taxable year are allowable only if the loss exceeds \$100 per casualty or theft.²⁸ In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's AGI.²⁹ If the disaster occurs in a presidentially-declared disaster area, the taxpayer may elect to take into account the casualty loss in the taxable year immediately preceding the taxable year in which the disaster occurs.³⁰

Earned Income Tax Credit (EITC) and Child Tax Credit (CTC)

An eligible individual is allowed an EITC equal to the credit percentage of earned income (up to an "earned income amount") for the tax year.³¹ For 2017, the earned income amount is \$6,670 for taxpayers with no qualifying children, \$10,000 for those with one qualifying child, and \$14,040 for those with two or more qualifying children.

For purposes of the EITC, earned income includes wages, salaries, tips, and other employee compensation, but only if those amounts are includible in gross income for the taxable year; plus net earnings from self-employment less the deduction for half of self-employment tax³² for the year.³³

Individuals can claim a \$1,000 CTC for each qualifying child the taxpayer can claim as a dependent.³⁴ The child must be under 17 and a U.S. citizen or resident alien.³⁵ The amount of the allowable credit is reduced (not below zero) by \$50 for each \$1,000 (or fraction thereof) of modified AGI (AGI increased by excluded foreign, possession, and Puerto Rico income) above: \$110,000 for joint filers, \$75,000 for unmarried individuals, and \$55,000 for married taxpayers filing separately.³⁶ To the extent the CTC exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit equal to 15 percent of earned income in excess of a threshold dollar amount.³⁷

²⁷ IRC section 165.

²⁸ IRC section 165(h)(1).

²⁹ IRC section 165(h)(2).

³⁰ IRC section 165(i).

³¹ IRC section 32.

³² IRC section 164(f).

³³ IRC section 32(c)(2)(A).

³⁴ IRC section 24.

³⁵ IRC section 24(c).

³⁶ IRC section 24(b).

³⁷ IRC section 24(d).

New Federal Law (Uncodified Act section 504 affecting IRC sections 24, 32, 56, 63, 68, 165, 170, 509, 4966, and 6213)

Temporary Suspension of Limitations on Charitable Contributions

For qualifying charitable contributions associated with qualified hurricane relief, the provision:

- Temporarily suspends the majority of the AGI limitations on charitable contributions,
- Provides that such contributions will not be taken into account for purposes of applying AGI and carryover period limitations to other contributions,
- Provides eased rules governing the treatment of excess contributions, and
- Provides an exception from the overall limitation on itemized deductions for certain qualified contributions.

Qualified contributions must be paid during the period beginning on August 23, 2017, and ending on December 31, 2017, in cash to an organization to which individual contributions are limited to 50 percent of AGI (determined without regard to any net operating loss carryback),³⁸ for relief efforts in the Hurricanes Harvey, Irma, or Maria disaster areas. Qualified contributions must also be substantiated, with a contemporaneous written acknowledgement that the contribution was or is to be used for relief efforts, and the taxpayer must make an election to apply these provisions. For partnerships and S corporations, the election is made separately by each partner or shareholder.

Casualty Losses

For taxpayers claiming a net disaster loss, the provision eliminates the current law requirement that personal casualty losses must exceed 10 percent of AGI to qualify for a deduction. The provision also eliminates the current law requirement that taxpayers must itemize deductions to access this tax relief for losses by increasing an individual taxpayer's standard deduction by the net disaster loss.

The law which generally disallows the standard deduction for alternative minimum tax purposes, does not apply for the portion of the standard deduction attributable to the net disaster loss. In addition, the provision increases the \$100 per-casualty floor to \$500 for qualified disaster-related personal casualty losses.

Special Rule for Determining Earned Income for the EITC and CTC

The provision stipulates that, in the case of a qualified individual, if the earned income of the taxpayer for the taxable year which includes the applicable date is less than the taxpayer's earned income for the preceding tax year, then the taxpayer may, for purposes of the EITC and CTC, substitute the earned income for the preceding year for the earned income for the taxable year that includes the applicable date. If the election is made, it applies for purposes of both the refundable EITC and CTC.

³⁸ IRC section 170(b)(1)(A).

For Hurricane Harvey, a qualified individual is one whose principal place of abode on August 23, 2017, was located either in the Hurricane Harvey disaster zone, or in the Hurricane Harvey disaster area, and the individual was displaced from their principal place of abode by reason of Hurricane Harvey. Similar definitions apply for Hurricane Irma using a September 4, 2017, date and Hurricane Maria using a September 16, 2017, date. In the case of joint filers, the above election may apply if either spouse is a qualified individual.

Effective Date

The provision is effective for charitable contributions made during the period August 23, 2017, through December 31, 2017, for casualty losses arising on August 23, 2017, for Hurricane Harvey, September 4, 2017, for Hurricane Irma, and September 16, 2017, for Hurricane Maria; and for determining earned income for taxable years beginning after December 31, 2016.

California Law (R&TC sections 17052, 17062, 17072, 17073.5, 17077, 17201, 17207, 17276, 24347, 24347.5, 24357 – 24357.9, and 24416)

Temporary Suspension of Limitations on Charitable Contributions

Under the PITL, California generally conforms to the federal charitable contribution rules under IRC section 170 as of the “specified date” of January 1, 2015,³⁹ and as a result, does not conform to the hurricane relief suspension of AGI limitations, exclusion of carryover period limitations to other contributions, eased rules governing the treatment of excess contributions, and exception from the overall limitation on itemized deductions.

Under the CTL, California does not conform to IRC section 170, but instead has stand-alone law that is generally similar to federal law allowing corporations a deduction for charitable contributions.⁴⁰ There are no similar provisions for hurricane relief suspension of AGI limitations, exclusion of carryover period limitations to other contributions, and eased rules governing the treatment of excess contributions.

Casualty Losses

California conforms by reference to IRC section 165, relating to losses, as of the “specified date” of January 1, 2015.⁴¹ Thus, under California law personal casualty or theft losses are deductible for individual taxpayers to the extent they exceed \$100 per casualty or theft, and aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer’s AGI.

³⁹ R&TC section 17201 conforms to IRC section 170, relating to charitable, etc., contributions and gifts, as of the “specified date” of January 1, 2015, with modifications in R&TC sections 17206, 17275.2, 17275.3, and 17275.5.

⁴⁰ R&TC sections 24357 – 24359.1.

⁴¹ R&TC section 17024.5.

California does not conform to the federal standard deduction amounts, but instead has its own standard-deduction provision.⁴² Thus, the standard deduction is unaffected by qualified disaster-related personal casualty losses.

Special Rule for Determining Earned Income for the EITC and CTC

For each taxable year beginning on or after January 1, 2015, California's PITL conforms to the federal EITC as in effect under federal law for that taxable year, with modifications. The definition of earned income is modified to include wages, salaries, tips, and other employee compensation, but only if such amounts are subject to California withholding.⁴³ Additionally, net earnings from self-employment is included in the definition of earned income for taxable years beginning on or after January 1, 2017.⁴⁴

Thus, California does not conform to the provision to substitute the earned income for the preceding year for the earned income for the taxable year that includes the applicable dates during which individuals were displaced from their principal place of abode in hurricane zones and areas.

Impact on California Revenue

Not applicable.

⁴² R&TC section 17073.5.

⁴³ Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

⁴⁴ SB 106 (Committee on Budget and Fiscal Review, Chapter 96, Statutes of 2017).

*An Act to Provide for Reconciliation Pursuant to Titles II and V of the
Concurrent Resolution on the Budget for Fiscal Year 2018
Public Law 115-97, December 22, 2017*

*An Act to Provide for Reconciliation Pursuant to Titles II and V of the
Concurrent Resolution on the Budget for Fiscal Year 2018
Public Law 115-97, December 22, 2017*

TITLE I, Subtitle C—Business Related Provisions

Part V—Business Credits

<u>Section</u>	<u>Section Title</u>
13401	Modification of Orphan Drug Credit

Background

IRC section 45C provides a 50-percent business tax credit for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as “orphan drugs.” Qualified clinical testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (FDA) but before the drug has been approved for sale by the FDA.⁴⁵ A rare disease or condition is defined as one that (1) affects fewer than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug.⁴⁶

Amounts included in computing the credit under this section are excluded from the computation of the research credit under IRC section 41.⁴⁷

New Federal Law (IRC section 45C)

The provision reduces the credit rate to 25 percent of qualified clinical testing expenses.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law

California does not conform to IRC section 45C, relating to the orphan drug credit, and has no comparable credit.

Impact on California Revenue

Not applicable.

⁴⁵ IRC section 45C(b).

⁴⁶ IRC section 45C(d).

⁴⁷ IRC section 45C(c).

*An Act to Provide for Reconciliation Pursuant to Titles II and V of the
Concurrent Resolution on the Budget for Fiscal Year 2018
Public Law 115-97, December 22, 2017*

<u>Section</u>	<u>Section Title</u>
13402	Rehabilitation Credit Limited to Certified Historic Structures

Background

Present law provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) \$5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

New Federal Law (IRC section 47)

The provision repeals the 10-percent credit for pre-1936 buildings and retains the 20-percent credit for qualified rehabilitation expenditures with respect to a certified historic structure, with a modification. Under the provision, the credit allowable for a taxable year during the five-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service is an amount equal to the ratable share. The ratable share for a taxable year during the five-year period is the amount equal to 20 percent of the qualified rehabilitation expenditures for the building, as allocated ratably to each taxable year during the five-year period. It is intended that the sum of the ratable shares for the taxable years during the five-year period does not exceed 100 percent of the credit for qualified rehabilitation expenditures for the qualified rehabilitated building.

Effective Dates

The provision applies to amounts paid or incurred after December 31, 2017. A transition rule provides that in the case of qualified rehabilitation expenditures (for either a certified historic structure or a pre-1936 building), with respect to any building owned or leased (as provided under present law) by the taxpayer at all times on and after January 1, 2018, the 24-month period

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selected by the taxpayer (IRC section 47(c)(1)(C)(i)), or the 60-month period selected by the taxpayer under the rule for phased rehabilitation (IRC section 47(c)(1)(C)(ii)), is to begin not later than the end of the 180-day period beginning on the date of the enactment of the Act, and the amendments made by the provision apply to such expenditures paid or incurred after the end of the taxable year in which such 24-month or 60-month period ends.

California Law

California does not conform to IRC section 47, relating to the rehabilitation credit, and has no comparable credit.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
13403	Employer Credit for Paid Family and Medical Leave

Background

Present law does not provide a credit to employers for compensation paid to employees while on leave.

New Federal Law (IRC section 45S)

The provision allows eligible employers to claim a general business credit equal to 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is 50 percent of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent. The maximum amount of family and medical leave that may be taken into account with respect to any employee for any taxable year is 12 weeks.

An eligible employer is one who has in place a written policy that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and who allows all less-than-full-time qualifying employees a commensurate amount of leave in proportion to the part-time employee's expected work hours. For purposes of this requirement, leave paid for by a State or local government is not taken into account. A "qualifying employee" means any employee as defined in section 3(e) of the Fair Labor Standards Act of 1938 who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess

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of 60 percent of the compensation threshold for highly compensated employees.⁴⁸ The Secretary will make determinations as to whether an employer or an employee satisfies the applicable requirements for an eligible employer or qualifying employee, based on information provided by the employer.

“Family and medical leave” is defined as leave described under sections 102(a)(1)(a)-(e) or 102(a)(3) of the Family and Medical Leave Act of 1993.⁴⁹ If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave would not be considered to be family and medical leave.

Effective Dates

The provision is generally effective for wages paid in taxable years beginning after December 31, 2017, and would not apply to wages paid in taxable years beginning after December 31, 2019.

California Law

California does not conform to new IRC section 45S, relating to the new employer credit for paid family and medical leave, and has no comparable credit.

California extends disability compensation to people who take time off work to care for a seriously ill child, spouse, parent, domestic partner, or to bond with a new baby or adopted child. Because the benefits paid are in the nature of unemployment compensation, California law considers it nontaxable income for state purposes. The Paid Family Leave program is part of the State Disability Insurance program administered by the Employment Development Department (EDD).

Impact on California Revenue

Not applicable.

⁴⁸ IRC section 414(g)(1)(B) (\$120,000 for 2017).

⁴⁹ In order to be an eligible employer, an employer must provide certain protections applicable under the Family and Medical Leave Act of 1993, regardless of whether they otherwise apply. Specifically, the employer must provide paid family and medical leave in compliance with a policy which ensures that the employer will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy and will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy.

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<u>Section</u>	<u>Section Title</u>
13404	Repeal of Tax Credit Bonds

Background

In General

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current tax-credit bonds include qualified tax-credit bonds, which have certain common general requirements, and include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds.⁵⁰

Qualified Tax-Credit Bonds

General Rules Applicable to Qualified Tax-Credit Bonds⁵¹

Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate for an issue of qualified tax-credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer.⁵² The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax (AMT) liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

New Clean Renewable Energy Bonds

New clean renewable energy bonds (New CREBs) may be issued by qualified issuers to finance qualified renewable energy facilities.⁵³ Qualified renewable energy facilities are facilities that: (1) qualify for the tax credit under IRC section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) are owned by a public power provider, governmental body, or cooperative electric company.

⁵⁰ The authority to issue two other types of tax-credit bonds, recovery zone economic development bonds and Build America Bonds, expired on January 1, 2011.

⁵¹ Certain other rules apply to qualified tax-credit bonds, such as maturity limitations, reporting requirements, spending rules, and rules relating to arbitrage. Separate rules apply in the case of tax-credit bonds which are not qualified tax-credit bonds (i.e., "recovery zone economic development bonds," and "Build America Bonds").

⁵² However, for new clean renewable energy bonds and qualified energy conservation bonds, the applicable credit rate is 70 percent of the otherwise applicable rate.

⁵³ IRC section 54C.

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The term “qualified issuers” includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. There was originally a national limitation for New CREBs of \$800 million. The national limitation was then increased by an additional \$1.6 billion in 2009. As with other tax-credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. However, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.⁵⁴

Qualified Energy Conservation Bonds

Qualified energy conservation bonds may be used to finance qualified conservation purposes. The term “qualified conservation purpose” means:

1. Capital expenditures incurred for purposes of: (a) reducing energy consumption in publicly owned buildings by at least 20 percent; (b) implementing green community programs;⁵⁵ (c) rural development involving the production of electricity from renewable energy resources; or (d) any facility eligible for the production tax credit under IRC section 45 (other than Indian coal and refined coal production facilities);
2. Expenditures with respect to facilities or grants that support research in: (a) development of cellulosic ethanol or other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; increasing the efficiency of existing technologies for producing nonfossil fuels; automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (e) technologies to reduce energy use in buildings;
3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;
4. Demonstration projects designed to promote the commercialization of: (a) green building technology; (b) conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak-use of electricity; and (e) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and
5. Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

⁵⁴ Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax-credit bonds at par.

⁵⁵ Capital expenditures to implement green community programs include grants, loans, and other repayment mechanisms to implement such programs. For example, States may issue these tax credit bonds to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a government bill or utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water-saving, storm water-reducing, or other efficiency measures.

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There was originally a national limitation on qualified energy conservation bonds of \$800 million. The national limitation was then increased by an additional \$2.4 billion in 2009. As with other qualified tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.⁵⁶

Qualified Zone Academy Bonds (QZABs)

QZABs are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy,” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A total of \$400 million of QZABs has been authorized to be issued annually in calendar years 1998 through 2008. The authorization was increased to \$1.4 billion for calendar year 2009, and also for calendar year 2010. For each of the calendar years 2011 through 2016, the authorization was set at \$400 million.

Qualified School Construction Bonds

Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bonds are issued by a State or local government within which such school is located; and (3) the issuer designates such bonds as a qualified school construction bond.

There is a national limitation on qualified school construction bonds of \$11 billion for calendar years 2009 and 2010, and zero after 2010. If an amount allocated is unused for a calendar year, it may be carried forward to the following and subsequent calendar years. Under a separate special rule, the Secretary of the Interior may allocate \$200 million of school construction bond authority for Indian schools.

Direct-Pay Bonds and Expired Tax-Credit Bond Provisions

The IRC provides that an issuer may elect to issue certain tax credit bonds as “direct-pay bonds.” Instead of a credit to the holder, with a “direct-pay bond” the Federal government pays the issuer a percentage of the interest on the bonds. The following tax credit bonds may be issued as direct-pay bonds: new clean renewable energy bonds, qualified energy conservation bonds, and qualified school construction bonds. Qualified zone academy bonds may not be issued as direct-

⁵⁶ Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

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pay using any national zone academy bond allocation for calendar years after 2011 or any carryforward of such allocations. The ability to issue Build America Bonds and Recovery Zone bonds, which have direct-pay features, has expired.

New Federal Law (IRC sections 54, 54A, 54B, 54C, 54D, 54E, 54F, 54AA, and 6431)

The provision prospectively repeals authority to issue tax-credit bonds and direct-pay bonds.

Effective Dates

The provision applies to bonds issued after December 31, 2017.

California Law

California does not conform to the federal tax credit bond provisions under subparts H, I, and J of part IV of subchapter A of chapter 1 of the IRC, or the credit for qualified bonds allowed to an issuer under IRC section 6431.

Impact on California Revenue

Not applicable.

Part VI—Provisions Related to Specific Entities and Industries
Subpart A—Partnership Provisions

<u>Section</u>	<u>Section Title</u>
13501	Treatment of Gain or Loss of Foreign Persons from Sale or Exchange of Interests in Partnerships Engaged In Trade or Business within the United States

Background

In General

A partnership generally is not treated as a taxable entity, but rather, income of the partnership is taken into account on the tax returns of the partners. The character (as capital or ordinary) of partnership items passes through to the partners as if the items were realized directly by the partners.⁵⁷ A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates, and deducts its distributive share of partnership items of deduction and loss. A partner's basis in the partnership interest is increased by any amount of gain and decreased by any amount of losses thus included. These basis adjustments prevent double taxation of partnership income to the partner. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset.⁵⁸ However, the amount of money and the fair market value of property received in the exchange that represent the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain.⁵⁹ In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election to do so,⁶⁰ or the partnership has a substantial built-in loss immediately after the transfer.⁶¹ If an election is in effect or the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner.

⁵⁷ IRC section 702.

⁵⁸ IRC section 741; *Pollack v. Commissioner*, 69 T.C. 142 (1977).

⁵⁹ IRC section 751(a). These ordinary income-producing assets are unrealized receivables of the partnership or inventory items of the partnership ("751 assets").

⁶⁰ IRC section 754.

⁶¹ IRC section 743(a).

These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee partner's basis in its partnership interest.⁶² The effect of the adjustments on the basis of partnership property is to approximate the result of a direct purchase of the property by the transferee partner.

Source of Gain or Loss on Transfer of a Partnership Interest

A foreign person that is engaged in a trade or business in the United States is taxed on income that is "effectively connected" with the conduct of that trade or business ("effectively connected gain or loss").⁶³ Partners in a partnership are treated as engaged in the conduct of a trade or business within the United States if the partnership is so engaged.⁶⁴ Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.⁶⁵

Among the factors taken into account in determining whether income, gain, or loss is effectively connected gain or loss are the extent to which the income, gain, or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the income, gain, or loss (the "asset use" and "business activities" tests).⁶⁶ In determining whether the asset use or business activities tests are met, due regard is given to whether such assets or such income, gain, or loss were accounted for through such trade or business. Thus, notwithstanding the general rule that source of gain or loss from the sale or exchange of personal property is generally determined by the residence of the seller,⁶⁷ a foreign partner may have effectively connected income by reason of the asset use or business activities of the partnership in which he is an investor.

Special rules apply to treat gain or loss from disposition of U.S. real property interests as effectively connected with the conduct of a U.S. trade or business.⁶⁸ To the extent that consideration received by the nonresident alien or foreign corporation for all or part of its interest in a partnership is attributable to a U.S. real property interest, that consideration is considered to be received from the sale or exchange in the United States of such property.⁶⁹ In certain circumstances, gain attributable to sales of U.S. real property interests may be subject to withholding tax of ten percent of the amount realized on the transfer.⁷⁰

⁶² IRC section 743(b).

⁶³ IRC sections 871(b), 864(c), 882.

⁶⁴ IRC section 875.

⁶⁵ IRC sections 871(b)(2), and 882(a)(2). Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, and is collected by withholding at the source of the payment. The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent is fixed, determinable, annual or periodical income that is not effectively connected with the conduct of a U.S. trade or business.

⁶⁶ IRC section 864(c)(2).

⁶⁷ IRC section 865(a).

⁶⁸ IRC section 897(a), (g).

⁶⁹ IRC section 897(g).

⁷⁰ IRC section 1445(e)(5). Temporary Treasury Regulation section 1.1445-11T(b),(d).

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Under a 1991 revenue ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the Internal Revenue Service (IRS) applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that U.S. business.⁷¹ Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a U.S. trade or business. However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.⁷²

New Federal Law (IRC sections 864 and 1446)

Under the provision, gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss.

The provision also requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

The Secretary shall issue such regulations as the Secretary determines appropriate for the application of the provision, including in exchanges described in IRC sections 332, 351, 354, 355, 356, or 361.

Also, the provisions related to withholding are effective for sales and exchanges after December 31, 2017. Additionally, under regulatory authority to carry out withholding requirements of the provision, the Secretary may provide guidance permitting a broker, as agent of the transferee, to deduct and withhold the tax equal to 10 percent of the amount realized on the disposition of a partnership interest to which the provision applies. For example, such guidance may provide that if an interest in a publicly traded partnership is sold by a foreign partner through a broker, the broker may deduct and withhold the 10-percent tax on behalf of the transferee.

⁷¹ Revenue Ruling 91-32, 1991-1 C.B. 107.

⁷² See *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

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The portion of the provision treating gain or loss on sale of a partnership interest as effectively connected income is effective for sales, exchanges, and dispositions on or after November 27, 2017. The portion of the provision requiring withholding on sales or exchanges of partnership interests is effective for sales, exchanges, and dispositions after December 31, 2017.

California Law (R&TC sections 18666, 25110, and 25116)

In General

California does not generally conform to the “effectively connected income” rules of IRC section 864, but does conform as of the “specified date” of January 1, 2015,⁷³ to IRC section 864(b)(2)(A)(ii) that, notwithstanding R&TC sections 23040 and 25101, income derived from or attributable to sources within the state shall not include income loss, or gain from stocks and securities received by an alien corporation on the corporation's own account.⁷⁴ However, California does not generally conform to other provisions of IRC section 864 that exclude certain activities or income as “trade or business within the United States”. As a result, California does not conform to the amended provisions of IRC section 864(c) relating to federal treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in a trade or business within the United States.

California conforms to the withholding of tax by a partnership with foreign partners under IRC section 1446, as of the “specified date” of January 1, 2015, with modifications for the rates of tax, but does not conform to the federal requirement to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.

Water's-Edge Method

Certain corporations doing business within and outside California may elect to determine their business income under a water-edge's method. This water's-edge election generally allows the unitary business to exclude foreign corporations from the calculation of business income, but includes the entire income and apportionment factors of certain affiliated foreign corporations. In addition, a foreign corporation with U.S. source income and a controlled foreign corporation with Subpart F income may have income and apportionment factors includible in the water's-edge return.

Under R&TC section 25110 and the regulations promulgated thereunder, California conforms to the extent income is sourced to the United States. Thus, California is already conformed to the federal treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in trade or business within the United States for water's-edge purposes.

⁷³ R&TC section 17024.5.

⁷⁴ R&TC section 23040.1.

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Impact on California Revenue

Baseline.

<u>Section</u>	<u>Section Title</u>
13502	Modify Definition of Substantial Built-In Loss in the Case of Transfer of Partnership Interest

Background

In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under IRC section 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer.⁷⁵

If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.⁷⁶ The adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

Under the provision, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than \$250,000 the fair market value of the partnership property.⁷⁷

Certain securitization partnerships and electing investment partnerships are not treated as having a substantial built-in loss in certain instances, and thus are not required to make basis adjustments to partnership property.⁷⁸ For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies.⁷⁹

New Federal Law (IRC section 743)

The provision modifies the definition of a substantial built-in loss for purposes of IRC section 743(d), affecting transfers of partnership interests. Under the provision, in addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss

⁷⁵ IRC section 743(a).

⁷⁶ IRC section 743(b).

⁷⁷ IRC section 743(d).

⁷⁸ See IRC section 743(e) (alternative rules for electing investment partnerships) and IRC section 743(f) (exception for securitization partnerships).

⁷⁹ Unlike in the case of an electing investment partnership, the partner-level loss limitation rule does not apply for a securitization partnership.

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in excess of \$250,000 upon a hypothetical disposition by the partnership of all of the partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to IRC section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of \$1 million, while the other asset, Asset Y, has a built-in loss of \$900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of \$300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of \$100,000 (\$1 million minus \$900,000). Partner C sells his partnership interest to another person, D, for \$33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of \$300,000 (one third of the built-in loss of \$900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.

Effective Dates

The provision applies to transfers of partnership interests after December 31, 2017.

California Law (R&TC section 17851)

California conforms, under the PITL, to federal laws that govern the taxation of partnerships as of the "specified date" of January 1, 2015⁸⁰ with modifications, but does not conform to the modification of the definition of substantial built-in loss in the case of the transfer of partnership interests.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modify Definition of Substantial Built-In Loss in the Case of Transfer of Partnership Interest For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- \$1,100,000	\$2,900,000	\$4,500,000

⁸⁰ R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015, under section 17024.5, except as otherwise provided.

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<u>Section</u>	<u>Section Title</u>
13503	Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss

Background

A partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year's losses) of the partner's interest in the partnership at the end of the partnership taxable year in which the loss occurred. Any disallowed loss is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years, to the extent that the partner's adjusted basis for its partnership interest at the end of any such year exceeds zero (before reduction by the loss for the year).⁸¹

A partner's basis in its partnership interest is increased by its distributive share of income (including tax-exempt income). A partner's basis in its partnership interest is decreased (but not below zero) by distributions by the partnership and its distributive share of partnership losses and expenditures of the partnership not deductible in computing partnership taxable income and not properly chargeable to capital account.⁸² In the case of a charitable contribution, a partner's basis is reduced by the partner's distributive share of the adjusted basis of the contributed property.⁸³

A partnership computes its taxable income in the same manner as an individual with certain exceptions. The exceptions provide, in part, that the deductions for foreign taxes and charitable contributions are not allowed to the partnership.⁸⁴ Instead, a partner takes into account its distributive share of the foreign taxes paid by the partnership and the charitable contributions made by the partnership for the taxable year.⁸⁵

However, in applying the basis limitation on partner losses, Treasury regulations do not take into account the partner's share of partnership charitable contributions and foreign taxes paid or accrued.⁸⁶ The IRS has taken the position in a private letter ruling that the basis limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's

⁸¹ IRC section 704(d) and Treasury Regulation section 1.704-1(d)(1).

⁸² IRC section 705(a).

⁸³ Revenue Ruling 96-11, 1996-1 C. B. 140.

⁸⁴ IRC section 703(a)(2)(B) and (C). In addition, IRC section 703(a)(2) provides that other deductions are not allowed to the partnership, notwithstanding that the partnership's taxable income is computed in the same manner as an individual's taxable income, specifically: personal exemptions, net operating loss deductions, certain itemized deductions for individuals, or depletion.

⁸⁵ IRC section 702.

⁸⁶ The regulation provides that "[i]f the partner's distributive share of the aggregate of items of loss specified in IRC section 702(a)(1), (2), (3), (8) [now (7)], and (9) [now (8)] exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under IRC section 704(d) must be allocated to his distributive share of each such loss." The regulation does not refer to IRC section 702(a)(4) (charitable contributions) and 702(a)(6) (foreign taxes paid or accrued). Treasury Regulation section 1.704-1(d)(2).

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charitable contributions.⁸⁷ While the regulations relating to the loss limitation do not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.⁸⁸

By contrast, under S corporation rules limiting the losses and deductions which may be taken into account by a shareholder of an S corporation to the shareholder's basis in stock and debt of the corporation, the shareholder's pro rata share of charitable contributions and foreign taxes are taken into account.⁸⁹ In the case of charitable contributions, a special rule is provided prorating the amount of appreciation not subject to the limitation in the case of charitable contributions of appreciated property by the S corporation.⁹⁰

New Federal Law (IRC section 704)

The provision modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions (as defined in IRC section 170(c)) and taxes (described in IRC section 901) paid or accrued to foreign countries and to possessions of the United States. Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. In the case of a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess.

Effective Dates

The provision applies to partnership taxable years beginning after December 31, 2017.

California Law (R&TC section 17851)

California conforms, under the PITL, to federal laws that govern the taxation of partnerships as of the "specified date" of January 1, 2015,⁹¹ with modifications, but does not conform to charitable contributions and foreign taxes being taken into account in determining limitation on allowance of partner's share of loss.

⁸⁷ Private Letter Ruling 8405084. And see William S. McKee, William F. Nelson and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, WG&L, 4th Edition (2011), paragraph 11.05[1][b], pp. 11-214 (noting that the "failure to include charitable contributions in the § 704(d) limitation is an apparent technical flaw in the statute. Because of it, a zero-basis partner may reap the benefits of a partnership charitable contribution without an offsetting decrease in the basis of his interest, whereas a fellow partner who happens to have a positive basis may do so only at the cost of a basis decrease.").

⁸⁸ IRC section 901.

⁸⁹ IRC section 1366(d) and IRC section 1366(a)(1). Under a related rule, the shareholder's basis in his interest is decreased by the basis (rather than the fair market value) of appreciated property by reason of a charitable contribution of the property by the S corporation (IRC section 1367(a)(2)).

⁹⁰ IRC section 1366(d)(4).

⁹¹ R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015 under section 17024.5, except as otherwise provided.

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Impact on California Revenue

Estimated Conformity Revenue Impact of Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	\$6,300,000	\$4,500,000	\$4,500,000

<u>Section</u>	<u>Section Title</u>
13504	Repeal of Technical Termination of Partnerships

Background

A partnership is considered as terminated under specified circumstances.⁹² Special rules apply in the case of the merger, consolidation, or division of a partnership.⁹³

A partnership is treated as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.⁹⁴

A partnership is also treated as terminated if within any 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.⁹⁵ This is sometimes referred to as a technical termination. Under regulations, the technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.⁹⁶

⁹² IRC section 708(b)(1).

⁹³ IRC section 708(b)(2). Mergers, consolidations, and divisions of partnerships take either an assets-over form or an assets-up form pursuant to Treasury Regulation section 1.708-1(c).

⁹⁴ IRC section 708(b)(1)(A).

⁹⁵ IRC section 708(b)(1)(B).

⁹⁶ Treasury Regulation section 1.708-1(b)(4).

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The effect of a technical termination is not necessarily the end of the partnership's existence, but rather the termination of some tax attributes. Upon a technical termination, the partnership's taxable year closes, potentially resulting in short taxable years.⁹⁷ Partnership-level elections generally cease to apply following a technical termination.⁹⁸ A technical termination generally results in the restart of partnership depreciation recovery periods.

New Federal Law (IRC section 708)

The provision repeals the IRC section 708(b)(1)(B) rule providing for technical terminations of partnerships. The provision does not change the present-law rule of IRC section 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Effective Dates

The provision applies to partnership taxable years beginning after December 31, 2017.

California Law (R&TC section 17851)

California conforms, under the PITL, to federal laws that govern the taxation of partnerships as of the "specified date" of January 1, 2015,⁹⁹ with modifications, but does not conform to the repeal of technical terminations of partnerships.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Technical Termination of Partnerships For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	\$12,000,000	\$5,800,000	\$5,300,000

⁹⁷ IRC section 706(c)(1); Treasury Regulation section 1.708-1(b)(3).

⁹⁸ Partnership level elections include, for example, the IRC section 754 election to adjust basis on a transfer or distribution, as well as other elections that determine the partnership's tax treatment of partnership items. A list of elections can be found at William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, 4th edition, para. 9.01[7], pp. 9-42 - 9-44.

⁹⁹ R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015 under section 17024.5, except as otherwise provided.

Subpart B—Insurance Reform

<u>Section</u>	<u>Section Title</u>
13511	Net Operating Losses of Life Insurance Companies

Background

A net operating loss (NOL) generally means the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.¹⁰⁰

For purposes of computing the AMT, a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income (AMTI) by more than 90 percent of the AMTI.¹⁰¹

In the case of a life insurance company, a deduction is allowed in the taxable year for operations loss carryovers and carrybacks, in lieu of the deduction for net operation losses allowed to other corporations.¹⁰² A life insurance company is permitted to treat a loss from operations (as defined under IRC section 810(c)) for any taxable year as an operations loss carryback to each of the three taxable years preceding the loss year and an operations loss carryover to each of the 15 taxable years following the loss year.¹⁰³

New Federal Law (IRC section 805)

The provision repeals the operations loss deduction for life insurance companies and allows the NOL deduction under IRC section 172.

Effective Dates

The provision applies to losses arising in taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the Franchise Tax Board (FTB). Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the Board of Equalization (BOE).

Impact on California Revenue

¹⁰⁰ IRC section 172(b)(2).

¹⁰¹ IRC section 56(d).

¹⁰² IRC sections 810, 805(a)(5).

¹⁰³ IRC section 810(b)(1).

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Not applicable.

<u>Section</u>	<u>Section Title</u>
13512	Repeal of Small Life Insurance Company Deduction

Background

The small life insurance company deduction for any taxable year is 60 percent of the amount of the tentative life insurance company taxable income (LICTI) for such taxable year that does not exceed \$3 million, reduced by 15 percent of the excess of tentative LICTI over \$3 million. The maximum deduction that can be claimed by a small company is \$1.8 million, and a company with a tentative LICTI of \$15 million or more is not entitled to any small company deduction. A small life insurance company for this purpose is one with less than \$500 million of assets.

New Federal Law (IRC section 806)

The provision repeals the small life insurance company deduction.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
13513	Adjustment for Change in Computing Reserves

Background

Change in Method of Accounting

In general, a taxpayer may change its method of accounting under IRC section 446 with the consent of the Secretary (or may be required to change its method of accounting by the Secretary). In such instances, a taxpayer generally is required to make an adjustment (a “section 481(a) adjustment”) to prevent amounts from being duplicated in, or omitted from, the calculation of the taxpayer’s income. Pursuant to IRS procedures, negative IRC section 481(a) adjustments

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generally are deducted from income in the year of the change whereas positive IRC section 481(a) adjustments generally are required to be included in income ratably over four taxable years.¹⁰⁴ However, IRC section 807(f) explicitly provides that changes in the basis for determining life insurance company reserves are to be taken into account ratably over 10 years.

10-Year Spread for Change in Computing Life Insurance Company Reserves

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.¹⁰⁵ Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Income or loss resulting from a change in the method of computing reserves is taken into account ratably over a 10-year period.¹⁰⁶ The rule for a change in basis in computing reserves applies only if there is a change in basis in computing the federally prescribed reserve (as distinguished from the net surrender value). Although life insurance tax reserves require the use of a Federally prescribed method, interest rate, and mortality or morbidity table, changes in other assumptions for computing statutory reserves (e.g., when premiums are collected and claims are paid) may cause increases or decreases in a company's life insurance reserves that must be spread over a 10-year period. Changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability.

If for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments to reserves is taken into account for the preceding taxable year.

New Federal Law (IRC section 807)

Income or loss resulting from a change in method of computing life insurance company reserves is taken into account consistent with IRS procedures, generally ratably over a four-year period, instead of over a 10-year period.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

¹⁰⁴ See, e.g., Revenue Procedure 2015-13, 2015-5 I.R.B. 419, and Revenue Procedure 2017-30, 2017-18 I.R.B. 1131.

¹⁰⁵ IRC section 807.

¹⁰⁶ IRC section 807(f).

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California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
13514	Repeal of Special Rule for Distributions to Shareholders from Pre-1984 Policyholders Surplus Account

Background

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to shareholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984¹⁰⁷ included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account.¹⁰⁸

Any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

¹⁰⁷ Pub. L. No. 98-369.

¹⁰⁸ IRC section 815.

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For taxable years beginning after December 31, 2004, and before January 1, 2007, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company were suspended. Distributions in those years were treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

New Federal Law (IRC section 815)

The provision repeals IRC section 815, the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a stock life insurance company.

In the case of any stock life insurance company with an existing policyholders surplus account (as defined in IRC section 815 before its repeal), tax is imposed on the balance of the account as of December 31, 2017. A life insurance company is required to pay tax on the balance of the account ratably over the first eight taxable years beginning after December 31, 2017. Specifically, the tax imposed on a life insurance company is the tax on the sum of life insurance company taxable income for the taxable year (but not less than zero) plus 1/8 of the balance of the existing policyholders surplus account as of December 31, 2017. Thus, life insurance company losses are not allowed to offset the amount of the policyholders surplus account balance subject to tax.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
13515	Modification of Proration Rules for Property and Casualty Insurance Companies

Background

The taxable income of a property and casualty insurance company is determined as the sum of its gross income from underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.

A proration rule applies to property and casualty insurance companies. In calculating the deductible amount of its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns.¹⁰⁹ This proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.

New Federal Law (IRC section 832)

The provision replaces the 15-percent reduction under present law with a reduction equal to 5.25 percent divided by the top corporate tax rate. For 2018 and thereafter, the corporate tax rate is 21 percent, and the percentage reduction is 25 percent under the proration rule for property and casualty insurance companies. The proration percentage will be automatically adjusted in the future if the top corporate tax rate is changed, so that the product of the proration percentage and the top corporate tax rate always equals 5.25 percent.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

¹⁰⁹ IRC section 832(b)(5).

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<u>Section</u>	<u>Section Title</u>
13516	Repeal of Special Estimated Tax Payments

Background

Allowance of Additional Deduction and Establishment of Special Loss Discount Account

Present law allows an insurance company required to discount its reserves an additional deduction that is not to exceed the excess of (1) the amount of the undiscounted unpaid losses over (2) the amount of the related discounted unpaid losses, to the extent the amount was not deducted in a preceding taxable year.¹¹⁰ The provision imposes the requirement that a special loss discount account be established and maintained, and that special estimated tax payments be made. Unused amounts of special estimated tax payments are treated as an IRC section 6655 estimated tax payment for the 16th year after the year for which the special estimated tax payment was made.

The total payments by a taxpayer, including IRC section 6655 estimated tax payments and other tax payments, together with special estimated tax payments made under this provision, are generally the same as the total tax payments that the taxpayer would make if the taxpayer did not elect to have this provision apply, except to the extent amounts can be refunded under the provision in the 16th year.

Calculation of Special Estimated Tax Payments Based on Tax Benefit Attributable to Deduction

More specifically, present law imposes a requirement that the taxpayer make special estimated tax payments in an amount equal to the tax benefit attributable to the additional deduction allowed under the provision. If amounts are included in gross income as a result of a reduction in the taxpayer's special loss discount account or the liquidation or termination of the taxpayer's insurance business, and an additional tax is due for any year as a result of the inclusion, then an amount of the special estimated tax payments equal to such additional tax is applied against such additional tax. If there is an adjustment reducing the amount of additional tax against which the special estimated tax payment was applied, then in lieu of any credit or refund for the reduction, a special estimated tax payment is treated as made in an amount equal to the amount that would otherwise be allowable as a credit or refund.

The amount of the tax benefit attributable to the deduction is to be determined (under Treasury regulations (which have yet to be promulgated)) by taking into account tax benefits that would arise from the carryback of any net operating loss for the year as well as current year benefits. In addition, tax benefits for the current and carryback years are to take into account the benefit of filing a consolidated return with another insurance company without regard to the consolidation limitations imposed by IRC section 1503(c).

¹¹⁰ IRC section 847.

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The taxpayer's estimated tax payments under IRC section 6655 are to be determined without regard to the additional deduction allowed under this provision and the special estimated tax payments. Legislative history¹¹¹ indicates that it is intended that the taxpayer may apply the amount of an overpayment of any IRC section 6655 estimated tax payments for the taxable year against the amount of the special estimated tax payment required under this provision. The special estimated tax payments under this provision are not treated as estimated tax payments for purposes of IRC section 6655 (e.g., for purposes of calculating penalties or interest on underpayments of estimated tax) when such special estimated tax payments are made.

Refundable Amount

To the extent that a special estimated tax payment is not used to offset additional tax due for any of the first 15 taxable years beginning after the year for which the payment was made, such special estimated tax payment is treated as an estimated tax payment made under IRC section 6655 for the 16th year after the year for which the special estimated tax payment was made. If the amount of such deemed IRC section 6655 payment, together with the taxpayer's other payments credited against tax liability for such 16th year, exceeds the tax liability for such year, then the excess (up to the amount of the deemed IRC section 6655 payment) may be refunded to the taxpayer to the same extent provided under present law with respect to overpayments of tax.

Regulatory Authority

In addition to the regulatory authority to adjust the amount of special estimated tax payments in the event of a change in the corporate tax rate, authority is provided to the Treasury to prescribe regulations necessary or appropriate to carry out the purposes of the provision.

Such regulations include those providing for the separate application of the provision with respect to each accident year. Separate application of the provision with respect to each accident year (i.e., applying a vintaging methodology) may be appropriate under regulations to determine the amount of tax liability for any taxable year against which special estimated tax payments are applied, and to determine the amount (if any) of special estimated tax payments remaining after the 15th year which may be available to be refunded to the taxpayer.

Regulatory authority is also provided to make such adjustments in the application of the provision as may be necessary to take into account the corporate AMT.

Under this regulatory authority, rules similar to those applicable in the case of a change in the corporate tax rate are intended to apply to determine the amount of special estimated tax payments that may be applied against tax calculated at the corporate AMT rate. The special estimated tax payments are not treated as payments of regular tax for purposes of determining the taxpayer's AMT liability.

¹¹¹ See H.R. Rep. No. 100-1104, Conference Report to accompany H.R. 4333, the Technical and Miscellaneous Revenue Act of 1988, October 21, 1988, p. 174.

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Regulations have yet to be promulgated under IRC section 847.

New Federal Law (IRC section 847)

The provision repeals IRC section 847. Thus, the election to apply IRC section 847, the additional deduction, special loss discount account, special estimated tax payment, and refundable amount rules of present law are eliminated.

The entire balance of an existing account is included in income of the taxpayer for the first taxable year beginning after 2017, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to this inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under IRC section 6655.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
13517	Computation of Life Insurance Tax Reserves

Background

In General

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.¹¹² Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

¹¹² IRC section 807.

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In computing the net increase or net decrease in reserves, six items are taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations under insurance and annuity contracts that do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance that are held for retired lives, premium stabilization, or a combination of both.

Life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules, but may not exceed the statutory reserve with respect to the contract (for regulatory reporting). In computing the federally prescribed reserve for any type of contract, the taxpayer must use the tax reserve method applicable to the contract, an interest rate for discounting of reserves to take account of the time value of money, and the prevailing commissioners' standard tables for mortality or morbidity.

Interest Rate

The assumed interest rate to be used in computing the federally prescribed reserve is the greater of the applicable Federal interest rate or the prevailing State assumed interest rate. The applicable Federal interest rate is the annual rate determined by the Secretary under the discounting rules for property and casualty reserves for the calendar year in which the contract is issued. The prevailing State assumed interest rate is generally the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued. In determining the highest assumed rates permitted in at least 26 States, each State is treated as permitting the use of every rate below its highest rate.

A one-time election is permitted (revocable only with the consent of the Secretary) to apply an updated applicable Federal interest rate every five years in calculating life insurance reserves. The election is provided to take into account the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration. The use of the updated applicable Federal interest rate under the election does not cause the recalculation of life insurance reserves for any prior year. Under the election no change is made to the interest rate used in determining life insurance reserves if the updated applicable Federal interest rate is less than one-half of one percentage point different from the rate used by the company in calculating life insurance reserves during the preceding five years.

New Federal Law (IRC section 807)

The provision provides that for purposes of determining the deduction for increases in certain reserves of a life insurance company, the amount of the life insurance reserves for any contract (other than certain variable contracts) is the greater of (1) the net surrender value of the contract (if any), or (2) 92.81 percent of the amount determined using the tax reserve method otherwise

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applicable to the contract as of the date the reserve is determined. In the case of a variable contract, the amount of life insurance reserves for the contract is the sum of (1) the greater of (a) the net surrender value of the contract, or (b) the separate-account reserve amount under IRC section 817 for the contract, plus (2) 92.81 percent of the excess (if any) of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined over the amount determined in (1). In no event shall the reserves exceed the amount which would be taken into account in determining statutory reserves. As under present law, no deduction for asset adequacy or deficiency reserves is allowed.

The amount of life insurance reserves may not exceed the annual statement reserves. A no-double-counting rule provides that no amount or item is taken into account more than once in determining any reserve under subchapter L of the IRC. For example, an amount taken into account in determining a loss reserve under IRC section 807 may not also be taken into account in determining a loss reserve under IRC section 832. Similarly, a loss reserve determined under the tax reserve method (whether the Commissioners Reserve Valuation Method, the Commissioner's Annuity Reserve Valuation Method, a principles-based reserve method, or another method developed in the future, that is prescribed for a type of contract by the National Association of Insurance Commissioners) may not again be taken into account in determining the portion of the reserve that is separately accounted for under IRC section 817 or be included also in determining the net surrender value of a contract.

The provision provides reserve rules for supplemental benefits and retains present-law rules regarding certain contracts issued by foreign branches of domestic life insurance companies. The provision requires the Secretary to provide for reporting (at such time and in such manner as the Secretary shall prescribe) with respect to the opening balance and closing balance or reserves and with respect to the method of computing reserves for purposes of determining income. For this purpose, the Secretary may require that a life insurance company (including an affiliated group filing a consolidated return that includes a life insurance company) is required to report each of the line item elements of each separate account by combining them with each such item from all other separate accounts and the general account, and to report the combined amounts on a line-by-line basis on the taxpayer's return. Similarly, the Secretary may in such guidance provide that reporting on a separate account by separate account basis is generally not permitted. Under existing regulatory authority, if the Secretary determines it is necessary in order to carry out and enforce this provision, the Secretary may require e-filing or comparable filing of the return on magnetic media or other machine readable form, and may require that the taxpayer provide its annual statement via a link, electronic copy, or other similar means.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017. For the first taxable year beginning after December 31, 2017, the difference in the amount of the reserve with respect to any contract at the end of the preceding taxable year and the amount of such reserve determined as if the proposal had applied for that year is taken into account for each of the eight taxable years following that preceding year, one-eighth per year.

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California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
13518	Modification of Rules for Life Insurance Proration for Purposes of Determining the Dividends Received Deduction

Background

Reduction of Reserve Deduction and Dividends Received Deduction to Reflect Untaxed Income

A life insurance company is subject to proration rules in calculating life insurance company taxable income.

The proration rules reduce the company's deductions, including reserve deductions and dividends received deductions, if the life insurance company has tax-exempt income, deductible dividends received, or other similar untaxed income items, because deductible reserve increases can be viewed as being funded proportionately out of taxable and tax-exempt income.

Under the proration rules, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest.¹¹³

Similarly, under the proration rules, a life insurance company is allowed a dividends received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends,¹¹⁴ but not for the policyholders' share. Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

¹¹³ IRC sections 807(a)(2)(B) and (b)(1)(B).

¹¹⁴ IRC sections 805(a)(4), 812.

Company's Share and Policyholder's Share

The life insurance company proration rules provide that the company's share, for this purpose, means the percentage obtained by dividing the company's share of the net investment income for the taxable year by the net investment income for the taxable year.¹¹⁵ Net investment income means 95 percent of gross investment income, in the case of assets held in segregated asset accounts under variable contracts, and 90 percent of gross investment income in other cases.¹¹⁶

Gross investment income includes specified items.¹¹⁷ The specified items include interest (including tax-exempt interest), dividends, rents, royalties and other related specified items, short-term capital gains, and trade or business income. Gross investment income does not include gain (other than short-term capital gain to the extent it exceeds net long-term capital loss) that is, or is considered as, from the sale or exchange of a capital asset. Gross investment income also does not include the appreciation in the value of assets that is taken into account in computing the company's tax reserve deduction under IRC section 817.

The company's share of net investment income, for purposes of this calculation, is the net investment income for the taxable year, reduced by the sum of (a) the policy interest for the taxable year and (b) a portion of policyholder dividends.¹¹⁸ Policy interest is defined to include required interest at the greater of the prevailing State assumed rate or the applicable Federal rate (plus some other interest items). Present law provides that in any case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what rate or rates are appropriate for this purpose.¹¹⁹ In 2007, the IRS issued Revenue Ruling 2007-54,¹²⁰ interpreting required interest under IRC section 812(b) to be calculated by multiplying the mean of a contract's beginning-of-year and end-of-year reserves by the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, for purposes of determining separate account reserves for variable contracts. However, Revenue Ruling 2007-54 was suspended by Revenue Ruling 2007-61, in which the IRS and the Treasury Department stated that the issues would more appropriately be addressed by regulation.¹²¹ No regulations have been issued to date.

¹¹⁵ IRC section 812(a).

¹¹⁶ IRC section 812(c).

¹¹⁷ IRC section 812(d).

¹¹⁸ IRC section 812(b)(1). This portion is defined as gross investment income's share of policyholder dividends.

¹¹⁹ Legislative history of IRC section 812 mentions that the general concept that items of investment yield should be allocated between policyholders and the company was retained from prior law. H. Rep. 98-861, Conference Report to accompany H.R. 4170, the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 1065 (June 23, 1984). *This concept is referred to in* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, December 31, 1984, p. 622, stating, "[u]nder the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (i.e., by reference to 'required interest')." This may imply that a reference to pre-1984-law regulations may be appropriate. See Revenue Ruling 2003-120, 2003-2 C.B. 1154, and Technical Advice Memoranda 20038008 and 200339049.

¹²⁰ 2007-38 I.R.B. 604.

¹²¹ 2007-42 I.R.B. 799.

General Account and Separate Accounts

A variable contract is generally a life insurance (or annuity) contract whose death benefit (or annuity payout) depends explicitly on the investment return and market value of underlying assets.¹²² The investment risk is generally that of the policyholder, not the insurer. The assets underlying variable contracts are maintained in separate accounts held by life insurers. These separate accounts are distinct from the insurer's general account in which it maintains assets supporting products other than variable contracts.

Reserves

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.¹²³ Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule,¹²⁴ in determining reserves for variable contracts, realized and unrealized gains are subtracted, and realized and unrealized losses are added, whether or not the assets have been disposed. The basis of assets in the separate account is increased to reflect appreciation, and reduced to reflect depreciation in value, that are taken into account in computing reserves for such contracts.

Dividends Received Deduction

A corporate taxpayer may partially or fully deduct dividends received.¹²⁵ The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns.

Limitation on Dividends Received Deduction under IRC Section 246(c)(4)

The dividends received deduction is not allowed with respect to stock either (1) held for 45 days or less during a 91-day period beginning 45 days before the ex-dividend date, or (2) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property.¹²⁶ The taxpayer's holding period is reduced for periods during which its risk of loss is reduced.¹²⁷

¹²² IRC section 817(d) provides a more detailed definition of a variable contract.

¹²³ IRC section 807.

¹²⁴ IRC section 817.

¹²⁵ IRC section 243 *et seq.* Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

¹²⁶ IRC section 246(c).

¹²⁷ IRC section 246(c)(4). For this purpose, the holding period is reduced for periods in which (1) the taxpayer has an obligation to sell or has shorted substantially similar stock; (2) the taxpayer has granted an option to buy substantially similar stock; or (3) under Treasury regulations, the taxpayer has diminished its risk of loss by holding other positions with respect to substantially similar or related property.

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New Federal Law (IRC section 812)

The provision modifies the life insurance company proration rule for reducing dividends received deductions and reserve deductions with respect to untaxed income. For purposes of the life insurance proration rule of IRC section 805(a)(4), the company's share is 70 percent. The policyholder's share is 30 percent.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
13519	Capitalization of Certain Policy Acquisition Expenses

Background

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and generally are amortized over the 120-month period beginning with the first month in the second half of the taxable year.¹²⁸

A special rule provides for 60-month amortization of the first \$5 million of specified policy acquisition expenses with a phase-out. The phase-out reduces the amount amortized over 60 months by the excess of the insurance company's specified policy acquisition expenses for the taxable year over \$10 million.

Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts the percentage is 1.75; for group life insurance contracts the percentage is 2.05; and for all other specified insurance contracts the percentage is 7.7.

¹²⁸ IRC section 848.

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With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof. A group life insurance contract is any life insurance contract that covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor, the premiums for which are determined on a group basis, and the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

New Federal Law (IRC section 848)

The provision extends the amortization period for specified policy acquisition expenses from a 120-month period to the 180-month period beginning with the first month in the second half of the taxable year. The provision does not change the special rule providing for 60-month amortization of the first \$5 million of specified policy acquisition expenses (with phase-out). The provision provides that for annuity contracts, the percentage is 2.09 percent; for group life insurance contracts the percentage is 2.45 percent; and for all other specified insurance contracts the percentage is 9.20 percent.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017. A transition rule provides that specified policy acquisition expenses first required to be capitalized in a taxable year beginning before January 1, 2018, will continue to be allowed as a deduction ratably over the 120-month period beginning with the first month in the second half of such taxable year.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
13520	Tax Reporting for Life Settlement Transactions

Background

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of \$600 or more made in the course of the payor's trade or business.¹²⁹ Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number (TIN).

Under present law, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed.

New Federal Law (New IRC section 6050Y)

The provision imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets forth rules for determining the basis of a life insurance or annuity contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

Reporting Requirements for Acquisitions of Life Insurance Contracts

Reporting Upon Acquisition of Life Insurance Contract

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

¹²⁹ IRC section 6041(a).

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Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and TIN, (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of Seller's Basis in the Life Insurance Contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (i.e., the investment in the contract within the meaning of IRC section 72(e)(6)), and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with Respect to Reportable Death Benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment, and (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.

Effective Dates

Under the provision, the reporting requirement is effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017.

California Law (R&TC section 18631)

California law provides, under the Administration of Franchise and Income Tax Law (AFITL)¹³⁰, that the FTB may require a copy of any information return required to be filed with the Secretary of the Treasury under IRC section 6050Y, relating to returns relating to certain life insurance contract transactions, at the time and in the form and manner as the FTB may, by forms and instructions, require.

¹³⁰ R&TC section 18631(c)(25).

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Impact on California Revenue

Not applicable.

Section

Section Title

13521

Clarification of Tax Basis of Life Insurance Contracts

Background

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.¹³¹

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited.¹³² Under the limitation, the excludable amount may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includible in the buyer's income.

¹³¹ IRC section 101(a)(1). In the case of certain accelerated death benefits and viatical settlements, special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). IRC section 101(g). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

¹³² IRC section 101(a)(2).

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Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract,¹³³ or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.¹³⁴

IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts. The guidance relates to the character of taxable amounts (ordinary or capital) and to the taxpayer's basis in the life insurance contract.

In Revenue Ruling 2009-13,¹³⁵ the IRS ruled that income recognized under IRC section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling.

In Revenue Ruling 2009-14,¹³⁶ the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includible as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

New Federal Law (IRC section 1016)

The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

Effective Dates

The provision is effective for transactions entered into after August 25, 2009.

¹³³ IRC section 101(a)(2)(A).

¹³⁴ IRC section 101(a)(2)(B).

¹³⁵ 2009-21 I.R.B. 1029.

¹³⁶ 2009-21 I.R.B. 1031.

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California Law (R&TC sections 18031, 18036, and 18036.5)

California conforms, under the PITL, to adjustments to basis under IRC section 1016, as of the specified date of January 1, 2015,¹³⁷ but does not conform to the federal clarification of tax basis for life insurance contracts.

Impact on California Revenue

Estimated Conformity Revenue Impact of Clarification of Tax Basis of Life Insurance Contracts ¹³⁸ For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- \$3,400,000	\$1,000,000	\$2,200,000

<u>Section</u>	<u>Section Title</u>
13522	Exception to Transfer for Valuable Consideration Rules

Background

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.¹³⁹

¹³⁷ R&TC section 17024.5.

¹³⁸ Amounts include revenue impacts for Act sections 13521 and 13522 combined.

¹³⁹ IRC section 101(a)(1). In the case of certain accelerated death benefits and viatical settlements, special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). IRC section 101(g). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

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Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited.¹⁴⁰ Under the limitation, the excludable amount may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration paid combined with subsequent premium payments on the contract are less than the amount of the death benefit later received under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract,¹⁴¹ or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.¹⁴²

IRS guidance sets forth details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts. The guidance relates to the character of taxable amounts (ordinary or capital) and to the taxpayer's basis in the life insurance contract.

In Revenue Ruling 2009-13,¹⁴³ the IRS ruled that income recognized under IRC section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain.

Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling.

In Revenue Ruling 2009-14,¹⁴⁴ the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

¹⁴⁰ IRC section 101(a)(2).

¹⁴¹ IRC section 101(a)(2)(A).

¹⁴² IRC section 101(a)(2)(B).

¹⁴³ 2009-21 I.R.B. 1029.

¹⁴⁴ 2009-21 I.R.B. 1031.

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New Federal Law (IRC section 101)

The provision provides that the exceptions to the transfer for value rules are inapplicable in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Effective Dates

The provision is effective for transfers occurring after December 31, 2017.

California Law (R&TC sections 17131 and 17132.5)

California conforms, under the PITL, to the treatment of certain death benefits under IRC section 101, as of the “specified date” of January 1, 2015,¹⁴⁵ with modifications, but does not conform to the federal exception to transfer for valuable consideration rules for life insurance contracts.

Impact on California Revenue

Estimated Conformity Revenue Impact of Exception to Transfer for Valuable Consideration Rules For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
See above Section 13521	See above Section 13521	See above Section 13521	See above Section 13521

Section

Section Title

13523 Modification of Discounting Rules for Property and Casualty Insurance Companies

Background

A property and casualty insurance company generally is subject to tax on its taxable income.¹⁴⁶ The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.¹⁴⁷ Among the items that are deductible in calculating underwriting income are additions to reserves for losses and expenses incurred.

¹⁴⁵ R&TC section 17024.5.

¹⁴⁶ See Part II.A.1 (Reduction in corporate tax rate).

¹⁴⁷ IRC section 831(a).

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To take account of the time value of money, discounting of unpaid losses is required. All property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement) are required to be discounted for Federal income tax purposes.

The discounted reserves are calculated using a prescribed interest rate which is based on the applicable Federal mid-term rate (“mid-term AFR”). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain “long-tail” lines of business, the 10-year period is extended, but not by more than five additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

Treasury publishes discount factors for each line of business to be applied by taxpayers for discounting reserves.¹⁴⁸ The discount factors are published annually, based on (1) the interest rate applicable to the calendar year, and (2) the loss payment pattern for each line of business as determined every five years.

New Federal Law (IRC section 846)

The provision modifies the reserve discounting rules applicable to property and casualty insurance companies. In general, the provision modifies the prescribed interest rate, extends the periods applicable under the loss payment pattern, and repeals the election to use a taxpayer’s historical loss payment pattern.

Interest Rate

The provision provides that the interest rate is an annual rate for any calendar year to be determined by Treasury based on the corporate bond yield curve (rather than the mid-term AFR as under present law). For this purpose, the corporate bond yield curve means, with respect to any month, a yield curve that reflects the average, for the preceding 60-month period, of monthly

¹⁴⁸ The most recent property and casualty reserve discount factors published by Treasury are in Revenue Procedure 2016-58, 2016-51 I.R.B. 839, and see Revenue Procedure 2012-44, 2012-49 I.R.B. 645.

yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.¹⁴⁹

Loss Payment Patterns

The provision extends the periods applicable for determining loss payment patterns. Under the provision, the maximum duration of the loss payment pattern is determined by the amount of losses remaining unpaid using aggregate industry experience for each line of business, rather than by a set number of years as under present law.

Like present law, the provision provides that Treasury determines a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years.

Under the provision, the present-law three-year and 10-year periods following the accident year are extended up to a maximum of 14 more years for the lines of business to which each period applies. For lines of business to which the three-year period applies, the amount of losses that would have been treated as paid in the third year after the accident year is treated as paid in that year and each subsequent year in an amount equal to the average of the amounts treated as paid in the first and second years (or, if less, the remaining amount). To the extent these unpaid losses have not been treated as paid before the 18th year after the accident year, they are treated as paid in that 18th year.

Similarly, for lines of business to which the 10-year period applies, the amount of losses that would have been treated as paid in the 10th year following the accident year is treated as paid in that year and each subsequent year in an amount equal to the average of the amounts treated as paid in the seventh, eighth, and ninth years (or if less, the remaining amount). To the extent these unpaid losses have not been treated as paid before the 25th year after the accident year, they are treated as paid in that 25th year.

The provision repeals the present-law rule providing that in the case of certain “long-tail” lines of business, the 10-year period is extended, but not by more than five additional years. The provision does not change the lines of business to which the three-year, and 10-year, periods, respectively, apply.

¹⁴⁹ This rule adopts the definition found in IRC section 430(h)(2)(D)(i) of the term “corporate bond yield curve.” IRC section 430, which relates to minimum funding standards for single-employer defined benefit pension plans, includes other rules for determining an “effective interest rate,” such as segment rate rules. The term “effective interest rate” along with these other rules, including the segment rate rules, do not apply for purposes of property and casualty insurance reserve discounting.

Election to Use Own Historical Loss Payment Pattern

The provision repeals the present-law election permitting a taxpayer to use its own (rather than an aggregate industry-experience-based) historical loss payment pattern with respect to all lines of business.

Effective Dates

The provision generally applies to taxable years beginning after December 31, 2017. Under a transitional rule for the first taxable year beginning in 2018, the amount of unpaid losses and expenses unpaid (under IRC section 832(b)(5)(B) and (6)) and the unpaid losses (under IRC sections 807(c)(2) and 805(a)(1)) at the end of the preceding taxable year are determined as if the provision had applied to these items in such preceding taxable year, using the interest rate and loss payment patterns for accident years ending with calendar year 2018. Any adjustment is spread over eight taxable years, *i.e.*, is included in the taxpayer's gross income ratably in the first taxable year beginning in 2018 and the seven succeeding taxable years. For taxable years subsequent to the first taxable year beginning in 2018, the provision applies to such unpaid losses and expenses unpaid (*i.e.*, unpaid losses and expenses unpaid at the end of the taxable year preceding the first taxable year beginning in 2018) by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Subpart C—Banks and Financial Instruments

<u>Section</u>	<u>Section Title</u>
13531	Limitation on Deduction for FDIC Premiums

Background

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation¹⁵⁰ generally comprises gross income less allowable deductions. A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.¹⁵¹

Corporations that make a valid election pursuant to IRC section 1362 of subchapter S of the IRC, referred to as S corporations, generally are not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns.

Banks, Thrifts, and Credit Unions

In General

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with specified exceptions.

¹⁵⁰ Corporations subject to tax are commonly referred to as C corporations after subchapter C of the IRC, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (real estate investment trusts) or in stock and securities (regulated investment companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to subchapter C.

¹⁵¹ IRC section 162(a). However, certain exceptions apply. No deduction is allowed for (1) any charitable contribution or gift that would be allowable as a deduction under IRC section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section; (2) any illegal bribe, illegal kickback, or other illegal payment; (3) certain lobbying and political expenditures; (4) any fine or similar penalty paid to a government for the violation of any law; (5) two-thirds of treble damage payments under the antitrust laws; (6) certain foreign advertising expenses; (7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or (8) certain applicable employee remuneration.

C Corporation Banks and Thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.¹⁵² A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.¹⁵³

S Corporation Banks

A bank is generally eligible to elect S corporation status under IRC section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in IRC section 585.¹⁵⁴

Special Bad Debt Loss Rules for Small Banks

IRC section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. The reserve method of accounting for bad debts, repealed in 1986¹⁵⁵ for most taxpayers, is allowed under IRC section 585 for any bank (as defined in IRC section 581) other than a large bank. For this purpose, a bank is a large bank if, for the taxable year (or for any preceding taxable year after 1986), the average adjusted basis of all its assets (or the assets of the controlled group of which it is a member) exceeds \$500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under IRC section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that generally looks to the ratio of (1) the total bad debts sustained during the taxable year and the five preceding taxable years to (2) the sum of the loans outstanding at the close of such taxable years.¹⁵⁶

Credit Unions

Credit unions are exempt from Federal income taxation.¹⁵⁷ The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater use of credit unions.¹⁵⁸ While significant differences

¹⁵² IRC section 581. See also Treasury Regulation section 1.581-1(a).

¹⁵³ While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank, there are certain exceptions and special rules for such institutions. Treasury Regulation section 1.581-2(a).

¹⁵⁴ IRC section 1361(b)(2)(A).

¹⁵⁵ Tax Reform Act of 1986, Pub. L. No. 99-514.

¹⁵⁶ IRC section 585(b)(2).

¹⁵⁷ IRC section 501(c)(14)(A). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions*, Report 3070, January 15, 2001, available at <https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc>.

¹⁵⁸ The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

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between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.¹⁵⁹

FDIC premiums

The Federal Deposit Insurance Corporation (FDIC) provides deposit insurance for banks and savings institutions. To maintain its status as an insured depository institution, a bank must pay semiannual assessments into the deposit insurance fund (DIF). Assessments for deposit insurance are treated as ordinary and necessary business expenses. These assessments, also known as premiums, are deductible once the all events test for the premium is satisfied.¹⁶⁰

New Federal Law (IRC section 162)

No deduction is allowed for the applicable percentage of any FDIC premium paid or incurred by the taxpayer. For taxpayers with total consolidated assets of \$50 billion or more, the applicable percentage is 100 percent. Otherwise, the applicable percentage is the ratio of the excess of total consolidated assets over \$10 billion to \$40 billion. For example, for a taxpayer with total consolidated assets of \$20 billion, no deduction is allowed for 25 percent of FDIC premiums. The provision does not apply to taxpayers with total consolidated assets (as of the close of the taxable year) that do not exceed \$10 billion.

FDIC premium means any assessment imposed under section 7(b) of the Federal Deposit Insurance Act.¹⁶¹ The term total consolidated assets has the meaning given such term under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.¹⁶²

For purposes of determining a taxpayer's total consolidated assets, members of an expanded affiliated group are treated as a single taxpayer. An expanded affiliated group means an affiliated group as defined in IRC section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to the exceptions from the definition of includible corporation for insurance companies and foreign corporations. A partnership or any other entity other than a corporation is treated as a member of an expanded affiliated group if such entity is controlled by members of such group.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

¹⁵⁹ The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions*, Report 3070, January 15, 2001, p. 2, available at <https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc>.

¹⁶⁰ Technical Advice Memorandum 199924060, March 5, 1999, and Revenue Ruling 80-230, 1980-2 C.B. 169, 1980.

¹⁶¹ 12 U.S.C. section 1817(b).

¹⁶² Pub. L. No. 111-203.

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California Law (R&TC sections 17201 and 24343)

California conforms, under the PITL and the CTL, to the allowance for trade or business expenses under IRC section 162, as of the “specified date” of January 1, 2015,¹⁶³ with modifications, but does not conform to the federal limitation on the deduction for FDIC premiums.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Deduction for FDIC Premiums For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	\$47,000,000	\$55,000,000	\$50,000,000

<u>Section</u>	<u>Section Title</u>
13532	Repeal of Advance Refunding Bonds

Background

IRC section 103 generally provides that gross income does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals).¹⁶⁴ Bonds issued to finance the activities of charitable organizations described in IRC section 501(c)(3) (“qualified 501(c)(3) bonds”) are one type of private activity bond. The exclusion from income for interest on State and local bonds only applies if certain IRC requirements are met.

The exclusion for income for interest on State and local bonds applies to refunding bonds but there are limits on advance refunding bonds. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond).

¹⁶³ R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the “specified date” of January 1, 2015, under section 17024.5, except as otherwise provided.

¹⁶⁴ IRC section 141.

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Different rules apply to current as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond.¹⁶⁵ Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the IRC limits advance refundings. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time.¹⁶⁶ Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.¹⁶⁷ Furthermore, in the case of an advance refunding bond that results in interest savings (e.g., a high interest rate to low interest rate refunding), the refunded bond must be redeemed on the first call date 90 days after the issuance of the refunding bond that results in debt service savings.¹⁶⁸

New Federal Law (IRC section 149)

The provision repeals the exclusion from gross income for interest on a bond issued to advance refund another bond.

Effective Dates

The provision applies to advance refunding bonds issued after December 31, 2017.

California Law

California does not conform to IRC section 149, relating to the exclusion from gross income for advance refunding bonds, or the federal rules relating to exempting the interest earned on state or municipal bonds. In addition, the federal “private activity bond” rules have not been adopted by California.

California State and Municipal Bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by California or a local government in this State.

¹⁶⁵ IRC section 149(d)(5).

¹⁶⁶ IRC section 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

¹⁶⁷ IRC section 149(d)(2).

¹⁶⁸ IRC section 149(d)(3)(A)(iii) and (B); Treasury Regulation section 1.149(d)-1(f)(3). A “call” provision provides the issuer of a bond with the right to redeem the bond prior to the stated maturity.

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Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the State and its political subdivisions is contained in the California Constitution.¹⁶⁹ The R&TC further provides, by statute, that the federal “private activity bond” analysis shall not be made in determining whether interest on bonds issued by the State or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a California state or local issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

California Conduit Revenue Bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a non-governmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond.

Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Since the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Since the conduit revenue bonds issued in California are issued by this State or a local government in this State, the interest paid on such bonds is exempt from State income taxation under the California Constitution.

¹⁶⁹ California Constitution, Article XIII, section 26, subdivision (b).

California Treatment of Federal Bond Interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. section 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable. Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Home Loan Mortgage Corporation (Freddie Macs).

California Franchise Tax Treatment

Interest received from federal, state, municipal, or other bonds is includable in the gross income of corporations taxable under the franchise tax. The franchise tax is a nondiscriminatory privilege tax for the right to exercise the corporate franchise and is not a tax on the income received, but instead merely uses that income of the year as the measure of the tax for the privilege of exercising the corporate franchise.

Impact on California Revenue

Not applicable.

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Subpart D—S Corporations

<u>Section</u>	<u>Section Title</u>
13541	Expansion of Qualifying Beneficiaries of an Electing Small Business Trust

Background

An electing small business trust (ESBT) may be a shareholder of an S corporation.¹⁷⁰ Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.¹⁷¹

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

New Federal Law (IRC section 1361)

The provision allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Effective Dates

The provision takes effect on January 1, 2018.

California Law (R&TC sections 17087.5 and 23800)

California conforms, under the PITL and the CTL, to the definition of S corporations under IRC section 1361, as of the specified date of January 1, 2015,¹⁷² with modifications, but does not conform to the federal expansion of qualifying beneficiaries of an electing small business trust who are eligible to be a shareholder of an S corporation.

¹⁷⁰ IRC section 1361(c)(2)(A)(v).

¹⁷¹ IRC section 1361(b)(1)(C) and (c)(2)(B)(v).

¹⁷² R&TC sections 17024.5, 23051.5, and RT&C section 23800.5.

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Impact on California Revenue

Estimated Conformity Revenue Impact of Expansion of Qualifying Beneficiaries of an Electing Small Business Trust ¹⁷³ For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- \$1,700,000	- \$900,000	- \$900,000

<u>Section</u>	<u>Section Title</u>
13542	Charitable Contribution Deduction for Electing Small Business Trusts

Background

An ESBT may be a shareholder of an S corporation.¹⁷⁴ The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT. In addition to nonseparately computed income or loss, an S corporation reports to its shareholders their pro rata share of certain separately stated items of income, loss, deduction, and credit.¹⁷⁵ For this purpose, charitable contributions (as defined in IRC section 170(c)) of an S corporation are separately stated and taken by the shareholder.

The treatment of a charitable contribution passed through by an S corporation depends on the shareholder. Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts,¹⁷⁶ rather than the deduction applicable to individuals,¹⁷⁷ applies to the trust. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of AGI generally with a five-year carryforward of amounts in excess of this limitation.

¹⁷³ Amounts include revenue impacts for Act sections 13541 and 13542 combined.

¹⁷⁴ IRC section 1361(c)(2)(A)(v).

¹⁷⁵ IRC section 1366(a)(1).

¹⁷⁶ IRC section 642(c).

¹⁷⁷ IRC section 170.

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New Federal Law (IRC section 641)

The provision specifies that a charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (R&TC section 17731 and 17731.5)

California conforms, under the PITL, to the imposition of tax on estates, trusts, beneficiaries, and decedents under IRC section 641, as of the specified date of January 1, 2015,¹⁷⁸ with modifications for the rates of tax and exemptions, but does not conform to the federal modifications to the charitable contribution deduction for electing small business trusts.

Impact on California Revenue

Estimated Conformity Revenue Impact of Charitable Contribution Deduction for Electing Small Business Trusts For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
See above Section 13541	See above Section 13541	See above Section 13541	See above Section 13541

Section

Section Title

13543 Modification of Treatment of S Corporation Conversions to C Corporations

Background

Changes in Accounting Method

Cash and Accrual Methods in General

Taxpayers using the cash method generally recognize items of income when actually or constructively received and items of expense when paid. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income recognition. It is the method generally used by most individual taxpayers, including farm and nonfarm sole proprietorships.

¹⁷⁸ R&TC section 17024.5.

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Taxpayers using an accrual method generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.¹⁷⁹ Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.¹⁸⁰ Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method. The accrual method is often used by businesses for financial accounting purposes.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method. Exceptions are made for farming businesses,¹⁸¹ qualified personal service corporations,¹⁸² and the aforementioned entities to the extent their average annual gross receipts do not exceed \$5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the “gross receipts test”).¹⁸³ The cash method may not be used by any tax shelter.¹⁸⁴ In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.¹⁸⁵ Such taxpayers generally are required to keep inventories and use an accrual method with respect to inventory items.¹⁸⁶

¹⁷⁹ See, e.g., IRC section 451.

¹⁸⁰ See, e.g., IRC section 461.

¹⁸¹ A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees. IRC section 448(d)(1).

¹⁸² A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. IRC section 448(d)(2).

¹⁸³ The gross receipts test is modified to apply to taxpayers with annual average gross receipts that do not exceed \$25 million for the three prior taxable-year period as part of this bill. See IRC section 3202 of the bill (Small business accounting method reform and simplification).

¹⁸⁴ IRC sections 448(a)(3) and (d)(3) and 461(i)(3) and (4). For this purpose, a tax shelter includes: (1) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale; (2) any syndicate (within the meaning of IRC section 1256(e)(3)(B)); or (3) any tax shelter as defined in IRC section 6662(d)(2)(C)(ii). In the case of a farming trade or business, a tax shelter includes any tax shelter as defined in IRC section 6662(d)(2)(C)(iii) or any partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, (1) if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

¹⁸⁵ Treasury Regulation sections 1.446-1(c)(2) and 1.471-1.

¹⁸⁶ IRC section 471 and Treasury Regulation sections 1.446-1(c)(2) and 1.471-1. However, an exemption is provided from the requirement to use inventories for taxpayers that meet the \$25 million gross receipts test. Accordingly, under the bill, such taxpayers are thus also eligible to use the cash method.

Procedures for Changing a Method of Accounting

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year.¹⁸⁷ Except as otherwise provided, IRC section 446(e) requires taxpayers to secure consent of the Secretary before changing a method of accounting. The regulations under this section provide rules for determining: (1) what a method of accounting is, (2) how an adoption of a method of accounting occurs, and (3) how a change in method of accounting is effectuated.¹⁸⁸

IRC section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a different method than the prior year (e.g., when changing from the cash method to an accrual method). In computing taxable income for the year of change, the taxpayer must take into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent items of income or expense from being duplicated or omitted.¹⁸⁹ The year of change is the taxable year for which the taxable income of the taxpayer is computed under a different method than the prior year.¹⁹⁰ Congress has provided the Secretary with the authority to prescribe the timing and manner in which such adjustments are taken into account in computing taxable income.¹⁹¹ Net adjustments that decrease taxable income generally are taken into account entirely in the year of change, and net adjustments that increase taxable income generally are taken into account ratably during the four-taxable-year period beginning with the year of change.¹⁹²

Post-Termination Distributions

Under present law, in the case of an S corporation that converts to a C corporation, distributions of cash by the C corporation to its shareholders during the post-termination transition period (to the extent of the amount in the accumulated adjustment account) are tax-free to the shareholders and reduce the adjusted basis of the stock.¹⁹³ The post-termination transition period is generally the one-year period after the S corporation election terminates.¹⁹⁴

¹⁸⁷ Treasury Regulation sections 1.446-1(e)(1).

¹⁸⁸ Treasury Regulation sections 1.446-1(e).

¹⁸⁹ IRC section 481(a)(2) and Treasury Regulation sections 1.481-1(a)(1).

¹⁹⁰ Treasury Regulation sections 1.481-1(a)(1).

¹⁹¹ IRC section 481(c). While Treasury regulations generally provide that the entire adjustments required by IRC section 481(a) are taken into account entirely in the year of change, the Secretary has provided the Commissioner with the authority to provide additional guidance regarding the taxable year or years in which the adjustments are taken into account. See Treasury Regulation sections 1.481-1(c)(2).

¹⁹² See Section 7.03 of Revenue Procedure 2015-13, 2015-5 I.R.B. 419.

¹⁹³ IRC section 1371(e)(1).

¹⁹⁴ IRC section 1377(b).

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New Federal Law (IRC section 481 and 1371)

Under the provision, any IRC section 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (*i.e.*, a change from the cash method to an accrual method) is taken into account ratably during the six-taxable-year period beginning with the year of change.¹⁹⁵ An eligible terminated S corporation is any C corporation which (1) is an S corporation the day before the enactment of this bill, (2) during the two-year period beginning on the date of such enactment revokes its S corporation election under IRC section 1362(a), and (3) all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment.

Under the provision, in the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account bears to the amount the accumulated earnings and profits.

Effective Dates

The provision is effective upon enactment.

California Law (R&TC sections 17087.5, 17551, 23806, 24667, 24710, and 24721)

Change in Method of Accounting

California conforms, under the PITL and the CTL, to adjustments required by changes in the method of accounting under IRC section 481, as of the specified date of January 1, 2015,¹⁹⁶ with modifications,¹⁹⁷ but does not conform to the federal modifications to the change in method of accounting treatment of S corporation conversions to C corporations.

Coordination with Subchapter C

California conforms, under the PITL and the CTL, to the application of subchapter C rules under IRC section 1371, as of the specified date of January 1, 2015,¹⁹⁸ with modifications¹⁹⁹, but does not conform to the federal changes to the application of Subchapter C rules to S corporations.

¹⁹⁵ Expands the universe of partnerships and C corporations eligible to use the cash method to include partnerships or C corporations with annual average gross receipts that do not exceed \$25 million for the three prior taxable-year period. Accordingly, an eligible terminated S corporation with annual average gross receipts that do not exceed \$25 million that used the cash method prior to revoking its S corporation election may be eligible to remain on the cash method as a C corporation.

¹⁹⁶ R&TC section 17024.5.

¹⁹⁷ R&TC section 24667 and 24710.

¹⁹⁸ R&TC section 17024.5.

¹⁹⁹ R&TC section 23806. This section requires that any election by an S corporation or its shareholders under IRC section 338, relating to certain stock purchases treated as asset acquisitions, for federal purposes shall be treated as an election for California and no separate election is allowed under R&TC paragraph (3) of subdivision (e) of sections 17024.5 and 23051.5.

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Impact on California Revenue

Estimated Conformity Revenue Impact of Modification of Treatment of S Corporation Conversions to C Corporations For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- \$25,000,000	- \$21,000,000	- \$20,000,000

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**Part VII—Employment
Subpart A—Compensation**

<u>Section</u>	<u>Section Title</u>
13601	Modification of Limitation on Excessive Employee Remuneration

Background

In General

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. IRC section 162(m) provides an explicit limitation on the deductibility of compensation expenses in the case of publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a covered employee of a publicly held corporation is limited to no more than \$1 million per year.²⁰⁰ The deduction limitation applies when the deduction attributable to the compensation would otherwise be taken.

Covered Employees

IRC section 162(m) defines a covered employee as (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 (Exchange Act) by reason of being among the corporation's four most highly compensated officers for the taxable year (other than the chief executive officer).²⁰¹ Treasury regulations under IRC section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Exchange Act.

In 2006, the Securities and Exchange Commission amended certain rules relating to executive compensation, including which officers' compensation must be disclosed under the Exchange Act. Under the new rules, such officers are (1) the principal executive officer (or an individual acting in such capacity), (2) the principal financial officer (or an individual acting in such capacity), and (3) the three most highly compensated officers, other than the principal executive officer or principal financial officer.

In response to the Securities and Exchange Commission's new disclosure rules, the IRS issued updated guidance on identifying which employees are covered by IRC section 162(m).²⁰² The new guidance provides that "covered employee" means any employee who is (1) as of the close of the taxable year, the principal executive officer (or an individual acting in such capacity) defined in

²⁰⁰ IRC section 162(m). This deduction limitation applies for purposes of the regular income tax and the AMT.

²⁰¹ IRC section 162(m)(3).

²⁰² Notice 2007-49, 2007-25 I.R.B. 1429.

reference to the Exchange Act, or (2) among the three most highly compensated officers²⁰³ for the taxable year (other than the principal executive officer or principal financial officer), again defined by reference to the Exchange Act. Thus, under current guidance, only four employees are covered under IRC section 162(m) for any taxable year. Under Treasury regulations, the requirement that the individual meet the criteria as of the last day of the taxable year applies to both the principal executive officer and the three highest compensated officers.²⁰⁴

Definition of Publicly Held Corporation

For purposes of the deduction disallowance of IRC section 162(m), a publicly held corporation means any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934.²⁰⁵ All U.S. publicly traded companies are subject to this registration requirement, including their foreign affiliates. A foreign company publicly traded through American depository receipts (ADRs) is also subject to this registration requirement if more than 50 percent of the issuer's outstanding voting securities are held, directly or indirectly, by residents of the United States and either (i) the majority of the executive officers or directors are United States citizens or residents, (ii) more than 50 percent of the assets of the issuer are located in the United States, or (iii) the business of the issuer is administered principally in the United States. Other foreign companies are not subject to the registration requirement.

Remuneration Subject to the Deduction Limitation

In General

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The \$1 million cap is reduced by excess parachute payments (as defined in IRC section 280G) that are not deductible by the corporation.²⁰⁶

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds \$1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis;²⁰⁷ (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation");²⁰⁸ (3) payments to a tax-favored retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as

²⁰³ By reason of being among the officers whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934.

²⁰⁴ Treasury Regulation sections 1.162-27(c)(2).

²⁰⁵ IRC section 162(m)(2).

²⁰⁶ IRC section 162(m)(4)(F).

²⁰⁷ IRC section 162(m)(4)(B).

²⁰⁸ IRC section 162(m)(4)(C).

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employer-provided health benefits and miscellaneous fringe benefits);²⁰⁹ and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993. In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of compensation is deferred until after termination of employment.

Performance-Based Compensation

Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors,²¹⁰ (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate majority-approved vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Compensation (other than stock options or other stock appreciation rights (SARs)) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. A stock option or SAR with an exercise price not less than the fair market value, on the date the option or SAR is granted, of the stock subject to the option or SAR, generally is treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met). This is the case because the amount of compensation attributable to the options or SARs received by the executive is based solely on an increase in the corporation's stock price.

Stock-based compensation is not treated as performance-based if it depends on factors other than corporate performance.

New Federal Law (IRC section 162)

Definition of Covered Employee

The provision revises the definition of covered employee to include both the principal executive officer and the principal financial officer. Further, an individual is a covered employee if the individual holds one of these positions at any time during the taxable year. The provision also defines as a covered employee the three (rather than four) most highly compensated officers for

²⁰⁹ IRC sections 105, 106, and 132.

²¹⁰ A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a qualified retirement plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (e.g., for services as a consultant) other than as a director.

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the taxable year (other than the principal executive officer or principal financial officer) who are required to be reported on the company's proxy statement (*i.e.*, the statement required pursuant to executive compensation disclosure rules promulgated under the Exchange Act) for the taxable year (or who would be required to be reported on such a statement for a company not required to make such a report to shareholders). This includes such officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation, as well as such officers of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year (for example, but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the nonapplication of the proxy statement requirement).

In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died. Compensation does not fail to be compensation with respect to a covered employee and thus subject to the deduction limit for a taxable year merely because the compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee's death, or to a former spouse pursuant to a domestic relations order.

Definition of Publicly Held Corporation

The provision extends the applicability of IRC section 162(m) to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The proposed definition may include certain additional corporations that are not publicly traded, such as large private C or S corporations.

Performance-Based Compensation and Commissions Exceptions

The provision eliminates the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit. Thus, such compensation is taken into account in determining the amount of compensation with respect to a covered employee for a taxable year that exceeds \$1 million and is thus not deductible under IRC section 162.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017. A transition rule applies to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date.

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California Law (R&TC sections 17201 and 24343)

California conforms, under the PITL and the CTL, to the federal treatment of certain excessive employee remuneration under IRC section 162 as of the “specified date” of January 1, 2015,²¹¹ but does not conform to the federal modifications to the limitation on excessive employee remuneration.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modification of Limitation on Excessive Employee Remuneration For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	\$24,000,000	\$35,000,000	\$34,000,000

<u>Section</u>	<u>Section Title</u>
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13602	Excise Tax on Excess Tax-Exempt Organization Executive Compensation
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Background

Taxable employers and other service recipients generally may deduct reasonable compensation expenses.²¹² However, in some cases, compensation in excess of specific levels is not deductible.

A publicly held corporation generally cannot deduct more than \$1 million of compensation (that is not compensation otherwise excepted from this limit) in a taxable year for each “covered employee.”²¹³ For this purpose, a covered employee is the corporation’s principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act as of the close of the taxable year, or any employee whose total compensation is required to be reported to shareholders under the Exchange Act by reason of being among the corporation’s three most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer).²¹⁴

²¹¹ R&TC section 17024.5.

²¹² IRC section 162(a)(1).

²¹³ IRC section 162(m)(1). Under IRC section 162(m)(6), limits apply to deductions for compensation of individuals performing services for certain health insurance providers.

²¹⁴ Notice 2007-49, 2007-2 I.R.B. 1429.

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Unless an exception applies, generally a corporation cannot deduct that portion of the aggregate present value of a “parachute payment” which equals or exceeds three times the “base amount” of certain service providers. The nondeductible excess is an “excess parachute payment.”²¹⁵ A parachute payment is generally a payment of compensation that is contingent on a change in corporate ownership or control made to certain officers, shareholders, and highly compensated individuals.²¹⁶ An individual’s base amount is the average annualized compensation includible in the individual’s gross income for the five taxable years ending before the date on which the change in ownership or control occurs.²¹⁷ Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, a simplified employee pension plan, or a simple retirement account.²¹⁸

These deduction limits generally do not affect a tax-exempt organization.

New Federal Law (IRC section 4960)

Under the provision, an excise tax will be imposed on covered employees of applicable tax-exempt organizations whose remuneration exceeds \$1 million, or who receive excess parachute payments.

Specifically, a tax, equal to 21 percent, will be imposed on (1) remuneration (excluding any excess parachute payment) paid in any taxable year by an applicable tax-exempt organization to a covered employee that exceeds \$1 million, plus (2) any excess parachute payment paid by an applicable tax-exempt organization to any covered employee.

Remuneration is treated as paid when there is not a substantial risk of forfeiture²¹⁹ of the rights to that remuneration. The tax imposed can apply to the value of remuneration that is vested (and any increases in that value or vested remuneration), even if it is not yet received. The applicable tax-exempt organization employer will be liable for any excise tax imposed on excess remuneration or excess parachute payment.

Remuneration That Exceeds \$1 Million

For purposes of this excise tax, an applicable tax-exempt organization is any organization which, for the tax year, is:

- Exempt from tax under IRC section 501(a),
- A farmer's cooperative organization under IRC section 521(b)(1),
- Has income excluded from tax from states, municipalities, etc.,²²⁰ or
- A political organization.²²¹

²¹⁵ IRC section 280G(a) and (b)(1).

²¹⁶ IRC section 280G(b)(2) and (c).

²¹⁷ IRC section 280G(b)(3).

²¹⁸ IRC sections 401(a), 403(a), 408(k), and 408(p).

²¹⁹ IRC section 457(f)(3)(B).

²²⁰ IRC section 115(1).

²²¹ IRC section 527(e)(1).

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For purposes of this excise tax, remuneration is considered to be wages (as defined under IRC section 3401(a)), but not including any designated Roth contribution. Remuneration also includes amounts required to be included in gross income under IRC section 457(f), relating to ineligible deferred compensation plans.

Remuneration does not include the portion of any remuneration paid to a licensed medical professional (which includes veterinarians) for medical or veterinary services performed by that professional. However, remuneration paid to such a medical professional in any other capacity (other than for the performance of medical or veterinary services) is taken into account.

A covered employee is any current or former employee of an applicable tax-exempt organization if the employee is (1) one of the five highest compensated employees of the organization for the tax year, or (2) was a covered employee of the organization, or any predecessor of the organization, for any tax year after December 31, 2016.

Any remuneration for which a deduction under IRC section 162(m) is not allowed is not included in remuneration used to calculate this excise tax. Remuneration of a covered employee paid by an applicable tax-exempt organization includes any remuneration paid for employment to a covered employee by a related person or government entity. A person or government entity is considered to be related to an applicable tax-exempt organization if the person or entity:

- Controls, or is controlled by, the applicable tax-exempt organization,
- Is controlled by a person, or persons, that control the organization,
- Is a supported organization under IRC section 509(f)(3),
- Is a supporting organization under IRC section 509(a)(3), or
- If the organization is a voluntary employees' beneficiary association (VEBA) under IRC section 509(c)(9), and establishes, maintains, or makes contributions to that VEBA.

If remuneration from more than one employer is used to calculate the excise tax, then each employer will be liable for the amount determined by the following ratio:

- The amount of remuneration paid by the employer to the employee, over
- The total amount of remuneration paid by all such employers to the employee.

Excess Parachute Payment.

For purposes of this excise tax, an “excess parachute payment” is the amount that exceeds the excess of any “parachute payment” over the “base amount” allocated to the payment. A parachute payment is any payment made as compensation to, or for the benefit of, a covered employee if (1) the payment is contingent on the employee's separation from employment with the employer, and (2) the aggregate present value of the compensation payments to, or for the benefit of, the employee is equal to, or greater than, three times the base amount.

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However, a parachute payment does not include any payment:

- Described in IRC section 280G(b)(6), relating to the exemption for payments under qualified plans,
- Made under or to an annuity contract under IRC section 403(b), or an IRC section 457(b) plan,
- Made to a licensed medical professional (including veterinarians) to the extent that the payment is for services performed by that medical professional, or
- Made to an individual who is not considered a highly compensated employee²²².

For these purposes, the “base amount” is determined in the same manner as under IRC section 280G(b)(3), relating to the base amount for a golden parachute payment. For purposes of determining an excess parachute payment, the rules of IRC sections 280G(d)(3) and 280G(d)(4) apply.

The IRS is directed to prescribe regulations that may be necessary to prevent the avoidance of the excise tax, including regulations preventing employees from being misclassified as contractors, or from being compensated through a pass-through or other entity to avoid such tax.

Effective Dates

The provisions are effective for taxable years beginning after December 31, 2017.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

²²² IRC section 414(g).

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<u>Section</u>	<u>Section Title</u>
13603	Treatment of Qualified Equity Grants

Background

Income Tax Treatment of Employer Stock Transferred to an Employee

Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of services.²²³ These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction.

Under these rules, an employee generally must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee's right to the stock is not substantially vested (referred to herein as "nonvested"), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee's right becomes substantially vested. In this case, the amount includible in the employee's income is the fair market value of the stock as of the date that the employee's right to the stock is substantially vested (less any amount paid for the stock). However, if the employee's right to the stock is nonvested at the time the stock is transferred to employee, under IRC section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a "section 83(b)" election.²²⁴ If a proper and timely election under IRC section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). An IRC section 83(b) election is available with respect to grants of "restricted stock" (nonvested stock), and does not generally apply to the grant of options.

²²³ IRC section 83. IRC section 83 applies generally to transfers of any property, not just employer stock, in connection with the performance of services by any service provider, not just an employee. However, the provision described herein applies only with respect to certain employer stock transferred to employees.

²²⁴ Under Treasury Regulation sections 1.83-2, the employee makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The employee must also provide a copy of the statement to the employer.

In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.²²⁵ An employee's right to stock or other property is transferable if the employee can transfer an interest in the property to any person other than the transferor of the property.²²⁶ Thus, generally, employer stock transferred to an employee by an employer is not transferable merely because the employee can sell it back to the employer.

In the case of stock transferred to an employee, the employer is allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the employee's income as a result of transfer of the stock.²²⁷ The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.²²⁸

These rules do not apply to the grant of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value.²²⁹ Instead, these rules apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee. An IRC section 83(b) election generally does not apply to the grant of options. If upon the exercise of an option, nonvested stock is transferred to the employee, an IRC section 83(b) election may apply. The employer's deduction is generally determined under the rules that apply to transfers of restricted stock, but a special accrual rule may apply under Treasury regulations when the transferred stock is substantially vested.²³⁰

Employment Taxes and Reporting

Employment taxes generally consist of taxes under the Federal Insurance Contributions Act (FICA), tax under the Federal Unemployment Tax Act (FUTA), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").²³¹ Unless an exception applies under the applicable rules, compensation provided to an employee constitutes wages subject to these taxes.

²²⁵ See IRC section 83(c)(1) and Treasury Regulation sections 1.83-3(c) for the definition of substantial risk of forfeiture.

²²⁶ See IRC section 83(c)(1) and Treasury Regulation sections 1.83-3(c) for the definition of substantial risk of forfeiture.

²²⁷ IRC section 83(h).

²²⁸ Treasury Regulation sections 1.83-6.

²²⁹ See IRC section 83(e)(3) and Treasury Regulation sections 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

²³⁰ Treasury Regulation sections 1.83-6(a)(3).

²³¹ IRC sections 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act (RRTA), IRC sections 3201-3241, to taxes equivalent to FICA taxes with respect to compensation as defined for RRTA purposes. IRC sections 3501-3510 provide additional rules relating to all these taxes.

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FICA imposes tax on employers and employees, generally based on the amount of wages paid to an employee during the year. Special rules as to the timing and amount of FICA taxes apply in the case of nonqualified deferred compensation, as defined for FICA purposes.²³²

The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance (OASDI) tax equal to 6.2 percent of covered wages up to the OASDI wage base (\$127,200 for 2017); and (2) the Medicare or hospital insurance (HI) tax equal to 1.45 percent of all covered wages.²³³ The employee portion of FICA tax generally must be withheld and, along with the employer portion, remitted to the Federal government by the employer. FICA tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.²³⁴

FUTA imposes a tax on employers of six percent of wages up to the FUTA wage base of \$7,000.

Income tax withholding generally applies when wages are paid by an employer to an employee, based on graduated withholding rates set out in tables published by the IRS.²³⁵ Like FICA tax withholding, income tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

An employer is required to furnish each employee with a statement of compensation information for a calendar year, including taxable compensation, FICA wages, and withheld income and FICA taxes.²³⁶ In addition, information relating to certain nontaxable items must be reported, such as certain retirement and health plan contributions. The statement, made on Form W-2, Wage and Tax Statement, must be provided to each employee by January 31 of the succeeding year.²³⁷

²³² IRC section 3121(v); Treasury Regulation sections 31.3121(v)(2).

²³³ The employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is \$250,000 in the case of a joint return, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case.

²³⁴ Under IRC section 3501(b), employment taxes with respect to noncash fringe benefits are to be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary of the Treasury (Treasury). Announcement 85-113, 1985-31 I.R.B. 31, provides guidance on the application of employment taxes with respect to noncash fringe benefits.

²³⁵ IRC section 3402. Specific withholding rates apply in the case of supplemental wages.

²³⁶ IRC sections 6041 and 6051.

²³⁷ Employers send Form W-2 information to the Social Security Administration, which records information relating to Social Security and Medicare and forwards the Form W-2 information to the IRS. Employees include a copy of Form W-2 with their income tax returns.

Statutory Options

Two types of statutory options apply with respect to employer stock: incentive stock options (ISOs) and options provided under an employee stock purchase plan (ESPP).²³⁸ Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. No amount is includible in an employee's income on the grant, vesting, or exercise of a statutory option.²³⁹ In addition, generally no deduction is allowed to the employer with respect to the option or the stock transferred to an employee.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a "disqualifying disposition"), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs and the employer may be allowed a corresponding deduction in the taxable year in which such disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Employment taxes do not apply with respect to the grant or vesting of a statutory option, transfer of stock pursuant to the option, or a disposition (including a disqualifying disposition) of the stock.²⁴⁰ However, certain special reporting requirements apply.

Nonqualified Deferred Compensation

Compensation is generally includible in an employee's income when paid to the employee. However, in the case of a nonqualified deferred compensation plan,²⁴¹ unless the arrangement either is exempt from or meets the requirements of IRC section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined²⁴²), even if payment will not occur until a later year.²⁴³ In general, to

²³⁸ IRC sections 421-424 govern statutory options. IRC section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.

²³⁹ Under IRC section 56(b)(3), this income tax treatment with respect to stock received on exercise of an ISO does not apply for purposes of the AMT under IRC section 55.

²⁴⁰ IRC sections 3121(a)(22), 3306(b)(19), and the last sentence of IRC section 421(b).

²⁴¹ Compensation earned by an employee is generally paid to the employee shortly after being earned. However, in some cases, payment is deferred to a later period, referred to as "deferred compensation." Deferred compensation may be provided through a plan that receives tax-favored treatment, such as a qualified retirement plan under IRC section 401(a). Deferred compensation provided through a plan that is not eligible for tax-favored treatment is referred to as "nonqualified" deferred compensation.

²⁴² Treasury Regulation sections 1.409A-1(d).

²⁴³ IRC section 409A and the regulations thereunder provide rules for nonqualified deferred compensation.

Compensation that fails to meet the requirements of IRC section 409A is also subject to an additional income tax of 20% on amounts includible in income and a potential interest factor tax (409A taxes). IRC section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

meet the requirements of IRC section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events.

Various exemptions from IRC section 409A apply, including transfers of property subject to IRC section 83.²⁴⁴ Nonqualified options are not automatically exempt from IRC section 409A, but may be structured so as not to be considered nonqualified deferred compensation.²⁴⁵ A restricted stock unit (RSU) is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or either). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of IRC section 409A. The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.²⁴⁶

New Federal Law (IRC sections 83, 409A, 422, 423, 3401, 3402, 6051, and 6652)

In General

The provision allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

If an employee elects to defer income inclusion under the provision, the income must be included in the employee's income for the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;²⁴⁷ (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an established securities market;²⁴⁸ (4) the date five years after the first date the employee's right to the stock becomes substantially vested; or (5) the date on which the employee revokes her inclusion deferral election.²⁴⁹

²⁴⁴ Treasury Regulation sections 1.409A-1(b)(6).

²⁴⁵ Treasury Regulation sections 1.409A-1(b)(5). In addition, statutory option arrangements are not nonqualified deferred compensation arrangements.

²⁴⁶ IRC section 404(a)(5).

²⁴⁷ Thus, for this purpose, the qualified stock is considered transferable if the employee has the ability to sell the stock to the employer (or any other person).

²⁴⁸ An established securities market is determined for this purpose by the Secretary, but does not include any market unless the market is recognized as an established securities market for purposes of another Code provision.

²⁴⁹ An inclusion deferral election is revoked at the time and in the manner as the Secretary provides.

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An inclusion deferral election is made in a manner similar to the manner in which an IRC section 83(b) election is made.²⁵⁰ The provision does not apply to income with respect to nonvested stock that is includible as a result of an IRC section 83(b) election. The provision clarifies that IRC section 83 (other than the provision), including subsection (b), shall not apply to RSUs. Therefore, RSUs are not eligible for an IRC section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

An employee may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation purchased any of its outstanding stock unless at least 25 percent of the total dollar amount of the stock so purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.²⁵¹ For purposes of this requirement, stock purchased from an individual is not treated as deferral stock (and the purchase is not treated as a purchase of deferral stock) if, immediately after the purchase, the individual holds any deferral stock with respect to which an inclusion deferral election has been in effect for a longer period than the election with respect to the purchased stock. Thus, in general, in applying the purchase requirement, an individual's deferral stock with respect to which an inclusion deferral election has been in effect for the longest periods must be purchased first. A corporation that has deferral stock outstanding as of the beginning of any calendar year and that purchases any of its outstanding stock during the calendar year must report on its income tax return for the taxable year in which, or with which, the calendar year ends the total dollar amount of the outstanding stock purchased during the calendar year and such other information as the Secretary may require for purposes of administering this requirement.

A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option.²⁵² In that case, the option is not treated as a statutory option and the rules relating to statutory options and related stock do not apply. In addition, an arrangement under which an employee may receive qualified stock is not treated as a nonqualified deferred compensation plan solely with respect to an employee who may receive qualified stock, such that when an inclusion deferral election is made in connection with the exercise of both ESPPs and ISOs, the options are not treated as statutory options but rather as nonqualified stock options for FICA purposes (in addition to being subject to section 83(i) for income tax purposes),

²⁵⁰ Thus, as in the case of an IRC section 83(b) election under present law, the employee must file with the IRS the inclusion deferral election and provide the employer with a copy.

²⁵¹ This requirement is met if the stock purchased by the corporation includes all the corporation's outstanding deferral stock.

²⁵² For purposes of the requirement that an ESPP provide employees with the same rights and privileges, the rules of the provision apply in determining which employees have the right to make an inclusion deferral election with respect to stock received under the ESPP.

Deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes an inclusion deferral election, the employer's deduction is deferred until the employer's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income as described in (1)-(5) above.

Qualified Employee and Qualified Stock

Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual (1) who was a one-percent owner of the corporation at any time during the current or 10 preceding calendar years,²⁵³ (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2),²⁵⁴ or (4) who has been one of the four highest compensated officers of the corporation for the current or any of the 10 preceding taxable years.²⁵⁵

Qualified stock is any stock of a corporation if:

- An employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- The option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation (as described below).

However, qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock can only be such if it relates to stock received in connection with options or RSUs, and does not include stock received in connection with other forms of equity compensation, including SARs or restricted stock.

A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year,²⁵⁶ and (2) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the

²⁵³ One-percent owner status is determined under the top-heavy rules for qualified retirement plans, that is, IRC section 416(i)(1)(B)(ii).

²⁵⁴ In the case of one-percent owners, this results from application of the attribution rules of IRC section 318 under IRC section 416(i)(1)(B)(i)(II). Family members are determined under IRC section 318(a)(1) and generally include an individual's spouse, children, grandchildren and parents.

²⁵⁵ These officers are determined on the basis of shareholder disclosure rules for compensation under the Securities Exchange Act of 1934, as if such rules applied to the corporation.

²⁵⁶ This requirement continues to apply up to the time an inclusion deferral election is made. That is, under the provision, no inclusion deferral election may be made with respect to qualified stock if any stock of the corporation is readily tradable on an established securities market at any time before the election is made.

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corporation in the United States (or any U.S. possession) are granted either stock options, or RSUs, with the same rights and privileges to receive qualified stock (“80-percent requirement”).²⁵⁷ For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules.^{258 259} However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU.²⁶⁰

For purposes of the provision, corporations that are members of the same controlled group²⁶¹ are treated as one corporation.

Notice, Withholding and Reporting Requirements

Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee's right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee (a) that the employee may (if eligible) elect to defer income inclusion with respect to the stock and (b) that, if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock), and the amount of income to be included at the end of the deferral period will be subject to withholding as provided under the provision, as well as of the employee's responsibilities with respect to required withholding. Failure to provide the notice may result in the imposition of a penalty of \$100 for each failure, subject to a maximum penalty of \$50,000 for all failures during any calendar year.

An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

²⁵⁷ In applying the requirement that 80 percent of employees receive stock options or RSUs, excluded employees and part-time employees are not taken into account. For this purpose, part-time employee is defined under IRC section 4980G(d)(4), as an employee who is customarily employed for fewer than 30 hours per week.

²⁵⁸ IRC section 423(b)(5).

²⁵⁹ Under a transition rule, in the case of a calendar year beginning before January 1, 2018, the 80-percent requirement is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

²⁶⁰ Under a transition rule, in the case of a calendar year beginning before January 1, 2018, the 80-percent requirement is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

²⁶¹ As defined in IRC section 414(b).

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For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers.²⁶² The employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

Effective Dates

The provision generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017. Under a transition rule, until the Secretary (or the Secretary's delegate) issues regulations or other guidance implementing the 80-percent and employer notice requirements under the provision, a corporation will be treated as complying with those requirements (respectively) if it complies with a reasonable good faith interpretation of the requirements. The penalty for a failure to provide the notice required under the provision applies to failures after December 31, 2017.

California Law (R&TC sections 17081, 17501, 17508.2, 24379, and 24601)

Treatment of Qualified Equity Grants

California conforms, under the PITL and the CTL, to the federal treatment of transfers of property in connection with the performance of services under IRC section 83, as of the "specified date" of January 1, 2015,²⁶³ but does not conform to the federal modifications regarding the treatment of qualified equity grants.

Nonqualified Deferred Compensation Plans, Incentive Stock Options, and Employee Stock Purchase Plans

California conforms, under the PITL and the CTL, by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), under R&TC sections 17501 and 24601.

²⁶² That is, the maximum rate of tax in effect for the year under IRC section 1. The provision specifies that qualified stock is treated as a noncash fringe benefit for income tax withholding purposes.

²⁶³ R&TC section 17024.5.

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However, R&TC sections 17501(b) and 24601(b) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC sections 17024.5 and 23051.5.

Thus, the federal modifications to nonqualified deferred compensation²⁶⁴ plans automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes, while California does not conform to the federal modifications to incentive stock options²⁶⁵ and employee stock purchase plans.²⁶⁶

Notice, Withholding and Reporting Requirements

California does not conform by reference to IRC section 3402, relating to income tax collected at source, but instead has stand-alone rules relating to income tax withholding.²⁶⁷

California does not conform by reference to IRC section 3401, relating to wage withholding. The EDD administers California’s wage withholding program.

Impact on California Revenue

Estimated Conformity Revenue Impact of Treatment of Qualified Equity Grants For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- \$12,000,000	- \$8,000,000	- \$6,800,000

²⁶⁴ IRC section 409A.

²⁶⁵ IRC section 422.

²⁶⁶ IRC section 423.

²⁶⁷ R&TC section 18662.

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<u>Section</u>	<u>Section Title</u>
13604	Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Corporations

Background

Income Tax Treatment of Employee Stock Compensation

In General

Employers may grant various forms of stock compensation to employees,²⁶⁸ including nonstatutory and statutory stock options, restricted stock, restricted stock units, and SARs. The tax treatment of these various forms of stock compensation depends on the specific terms and conditions of the arrangement and applicable rules.

Stock Compensation Treated as Property Transferred in Connection With the Performance of Services

IRC section 83 generally governs the taxation of transfers of any property in connection with the performance of services by any service provider. Typically, this encompasses the transfer of stock to an employee which is subject to conditions that amount to a substantial risk of forfeiture, called “restricted stock.” IRC section 83 also generally governs the taxation of nonstatutory (or nonqualified) stock options. In general, an employee’s right to stock or other property is subject to a substantial risk of forfeiture if the employee’s right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.²⁶⁹

Generally, an employee must recognize income in the taxable year in which the employee’s right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as “substantially vested”). Thus, if the employee’s right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee’s right to the stock is not substantially vested (referred to herein as “nonvested”), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee’s right becomes substantially vested. In this case, the amount includible in the employee’s income is the fair market value of the stock as of the date that the employee’s right to the stock is substantially vested (less any amount paid for the stock).²⁷⁰

²⁶⁸ The terms “employer” and “employee” are used, although the provision herein also applies to individuals who are not employees and the service recipients of such non-employee individuals.

²⁶⁹ See IRC section 83(c)(1) and Treasury Regulation sections 1.83-3(c) for the definition of substantial risk of forfeiture.

²⁷⁰ Under IRC section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a “section 83(b)” election. If a proper and timely election under IRC section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock).

These rules do not apply to the grant of a nonqualified option unless the option has a readily ascertainable fair market value.²⁷¹ Instead, these rules generally apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee.

Statutory Stock Options

Two types of statutory options apply with respect to employer stock: incentive stock options ISOs and options provided under an employee stock purchase plan ESPP.²⁷² Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. Unlike nonqualified options, statutory options may only be considered as such if granted to employees.²⁷³ No amount is includible in an employee's income on the grant, vesting, or exercise of a statutory option.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a "disqualifying disposition"), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Stock Compensation Treated As Deferred Compensation

An RSU is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock. An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the

²⁷¹ See IRC section 83(e)(3) and Treasury Regulation sections 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

²⁷² IRC sections 421-424 govern statutory options. IRC section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.

²⁷³ IRC sections 422(a)(2) and 423(a)(2).

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limits, of IRC section 409A,²⁷⁴ unless it meets an exemption from IRC section 409A. If the RSU either is exempt from or complies with IRC section 409A, the employee is subject to income taxation on receipt of cash or the transfer of shares attributable to the RSU.

A SAR is an arrangement under which an employee has the right to receive an amount (in the form of cash or stock) determined by reference to the appreciation in value of one or more shares of employer stock, based on the difference in the stock's value when the employee chooses to exercise the right and the value of the stock on the date of grant of the SAR. An SAR is generally taxable at the time of exercise on the amount of cash or value of stock transferred at the time of exercise of the SAR.²⁷⁵

Various exemptions from IRC section 409A apply, including transfers of property subject to IRC section 83, such as restricted stock.²⁷⁶ Nonqualified options and SARs are not automatically exempt from IRC section 409A, but may be structured so as not to be considered nonqualified deferred compensation.²⁷⁷ In addition, ISOs and ESPPs are exempt from IRC section 409A.²⁷⁸

IRC Section 4985 Excise Tax on Stock Compensation of Insiders of Expatriated Corporations

Under IRC section 4985, certain holders of stock options and other stock-based compensation are subject to an excise tax upon certain transactions that result in an expatriated corporation²⁷⁹ (also referred to as corporate inversions).²⁸⁰ The provision imposes an excise tax, currently at the rate of 15 percent, on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

²⁷⁴ IRC section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Unless an arrangement either is exempt from or meets the requirements of IRC section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined), even if payment will not occur until a later year. In general, to meet the requirements of IRC section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events. Compensation that fails to meet the requirements of IRC section 409A is also subject to an additional income tax of 20 percent on amounts includible in income and a potential interest factor tax (409A taxes). IRC section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

²⁷⁵ Revenue Ruling 80-300, 1980-2 C.B. 165.

²⁷⁶ Treasury Regulation sections 1.409A-1(b)(6).

²⁷⁷ Treasury Regulation sections 1.409A-1(b)(5).

²⁷⁸ Treasury Regulation sections 1.409A-1(b)(5)(ii).

²⁷⁹ IRC section 7874(a)(2).

²⁸⁰ For further discussion of the tax treatment of expatriated entities before the effective date of IRC section 7874 and concerns that led to the enactment of IRC sections 7874 and 4985, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005.

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A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,²⁸¹ or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),²⁸² directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as defined for this purpose) only if gain is recognized in whole or part by any shareholder by reason of the acquisition resulting in the corporate inversion.²⁸³

Specified stock compensation subject to the excise tax includes any payment (or right to payment)²⁸⁴ granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the corporate inversion. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including SARs, restricted stock units, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's nonqualified deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. A payment directly tied to the value of the stock is specified stock compensation.

²⁸¹ An expanded affiliated group is an affiliated group (under IRC section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined by substituting "more than 50 percent" for "at least 80 percent."

²⁸² An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

²⁸³ As referred to in IRC section 7874(a)(2)(B)(i).

²⁸⁴ Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

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The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the transaction and then reissues comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the provision, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under IRC section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

For specified stock compensation held on the expatriation date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date granted. Under the provision, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and SARs and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or an SAR is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or “spread”) because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the expatriation transaction (or the date of cancellation or grant, if applicable).

The excise tax also applies to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax.

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This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under IRC section 162(m), the limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the provision. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

New Federal Law (IRC section 4985)

The provision increases the 15 percent rate of excise tax, imposed on the value of stock compensation held by insiders of an expatriated corporation, to 20 percent.

Effective Dates

The provision applies to corporations first becoming expatriated corporations after the date of enactment, December 22, 2017.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Subpart B—Retirement Plans

<u>Section</u>	<u>Section Title</u>
13611	Repeal of Special Rule Permitting Recharacterization of Roth Conversions

Background

Individual Retirement Arrangements (IRA)

There are two basic types of IRAs under present law: traditional IRAs,²⁸⁵ to which both deductible and nondeductible contributions may be made,²⁸⁶ and Roth IRAs, to which only nondeductible contributions may be made.²⁸⁷ The principal difference between these two types of IRAs is the timing of income tax inclusion.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount (\$5,500 for 2017) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. The dollar limit is increased annually ("indexed") as needed to reflect increases in the cost-of living. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to \$1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI for the taxable year over certain indexed levels.²⁸⁸ To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible after-tax contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ before the close of a year is not permitted to make contributions to a traditional IRA for that year.

²⁸⁵ IRC section 408.

²⁸⁶ IRC sections 219(a) and 408(o).

²⁸⁷ IRC section 408A.

²⁸⁸ IRC section 219(g).

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Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of the individual's basis.²⁸⁹ All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels.²⁹⁰

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions.

Separation of Traditional and Roth IRA Accounts

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA.²⁹¹ The amount converted is includible in the taxpayer's income as if a withdrawal had been made.²⁹² The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

²⁸⁹ Basis results from after-tax contributions to traditional IRAs or a rollovers to traditional IRAs of after-tax amounts from another eligible retirement plan.

²⁹⁰ Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, as discussed below.

²⁹¹ Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

²⁹² Subject to various exceptions, distributions from an IRA before age 59½ that are includible in income are subject to a 10-percent early distribution tax under IRC section 72(t). An exception applies to an amount includible in income as a result of the conversion from a traditional IRA into a Roth IRA. However, the early distribution tax applies if the taxpayer withdraws the amount within five years of the conversion.

Rollovers to IRAs of distributions from tax-favored employer-sponsored retirement plans (that is, qualified retirement plans, tax-deferred annuity plans, and governmental eligible deferred compensation plans²⁹³) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan generally must be contributed to a traditional IRA, and distributions from a designated Roth account under an employer-sponsored plan must be contributed only to a Roth IRA. However, a distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from a tax-favored employer-sponsored plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions).²⁹⁴

Recharacterization of IRA Contributions

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year.²⁹⁵ In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

The amount transferred in a recharacterization must be accompanied by any net income allocable to the contribution. In general, even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a pro rata portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may establish multiple Roth IRAs, for example, Roth IRAs with different investment strategies, and divide the amount being converted among the IRAs. The individual can then choose whether to recharacterize any of the Roth IRAs as a traditional IRA by transferring the entire amount in the particular Roth IRA to a traditional IRA.²⁹⁶ For example, if the value of the assets in a particular Roth IRA declines after the conversion, the conversion can be reversed by recharacterizing that IRA as a traditional IRA. The individual may then later convert that traditional IRA to a Roth IRA (referred to as a reconversion), including only the lower value in income. Treasury regulations prevent the reconversion from taking place immediately after the recharacterization, by requiring a minimum period to elapse before the reconversion. Generally the reconversion cannot occur sooner than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.²⁹⁷

²⁹³ IRC sections 401(a), 403(a), 403(b) and 457(b).

²⁹⁴ As in the case of a conversion of an amount from a traditional IRA to a Roth IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from the Roth IRA within a specified five-year period after the rollover.

²⁹⁵ IRC section 408A(d)(6).

²⁹⁶ Treasury Regulation sections 1.408A-5, Q&A-2(b).

²⁹⁷ Treasury Regulation sections 1.408A-5, Q&A-9.

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New Federal Law (IRC section 408A)

Under the provision, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA.²⁹⁸

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law (R&TC sections 17501 and 24601)

California conforms, under the PITL and the CTL, by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), under R&TC sections 17501 and 24601.

However, R&TC sections 17501(b) and 24601(b) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC sections 17024.5 and 23051.5.

Thus, the federal repeal of the special rule permitting recharacterization of Roth conversions automatically applies under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

²⁹⁸ In addition, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, but the provision precludes the individual from later unwinding the conversion through a recharacterization.

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<u>Section</u>	<u>Section Title</u>
13612	Modification of Rules Applicable to Length of Service Award Plans

Background

Special rules apply to deferred compensation plans of State and local government and private, tax-exempt employers.²⁹⁹ However, an exception to these rules applies in the case of a plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by the volunteers. For this purpose, qualified services consist of firefighting and fire prevention services, emergency medical services, and ambulance services. An individual is treated as a bona fide volunteer for this purpose if the only compensation received by the individual for performing qualified services is in the form of (1) reimbursement or a reasonable allowance for reasonable expenses incurred in the performance of such services, or (2) reasonable benefits (including length of service awards) and nominal fees for the services, customarily paid in connection with the performance of such services by volunteers. The exception applies only if the aggregate amount of length of service awards accruing for a bona fide volunteer with respect to any year of service does not exceed \$3,000.

New Federal Law (IRC section 457)

The provision increases the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service to \$6,000 and adjusts that amount in \$500 increments to reflect changes in cost-of-living for years after the first year the provision is effective. In addition, under the provision, if the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. Actuarial present value is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation.

Effective Dates

The amendments to this provision are effective for taxable years beginning after December 31, 2017.

California Law (R&TC section 17551)

California conforms, under the PITL, by reference to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating to accounting periods and methods of accounting, consisting of IRC sections 441 through 483, inclusive, in R&TC section 17551(a) as of the "specified date" of January 1, 2015.³⁰⁰

²⁹⁹ IRC section 457.

³⁰⁰ R&TC section 17024.5.

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R&TC section 17551(c) specifically provides that federal changes to Subchapter E of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 441 through 483, inclusive, relating to accounting periods and methods of accounting, shall apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC section 17024.5.

The federal changes to IRC section 457 made by this provision are applicable for California purposes without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

<u>Section</u>	<u>Section Title</u>
13613	Extended Rollover Period for Plan Loan Offset Amounts

Background

Taxation of Retirement Plan Distributions

A distribution from a tax-favored employer-sponsored retirement plan (that is, a qualified retirement plan, IRC section 403(b) plan, or a governmental IRC section 457(b) plan) is generally includible in gross income, except in the case of a qualified distribution from a designated Roth account or to the extent the distribution is a recovery of basis under the plan or the distribution is contributed to another such plan or an IRA (referred to as eligible retirement plans) in a tax-free rollover.³⁰¹ In the case of a distribution from a retirement plan to an employee under age 59½, the distribution (other than a distribution from a governmental IRC section 457(b) plan) is also subject to a 10-percent early distribution tax unless an exception applies.³⁰²

A distribution from a tax-favored employer-sponsored retirement plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan.³⁰³ The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution (“60-day rollover”).

³⁰¹ IRC sections 402(a) and (c), 402A(d), 403(a) and (b), 457(a) and (e)(16).

³⁰² IRC section 72(t).

³⁰³ Certain distributions are not eligible rollover distributions, such as annuity payments, required minimum distributions, hardship distributions, and loans that are treated as deemed distributions under IRC section 72(p).

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Employer-sponsored retirement plans are required to offer an employee a direct rollover with respect to any eligible rollover distribution before paying the amount to the employee. If an eligible rollover distribution is not directly rolled over to an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.³⁰⁴

Employees who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent withheld will remain taxable unless the employee substitutes funds within the 60-day period.

Plan Loans

Employer-sponsored retirement plans may provide loans to employees. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan, including that the terms of the loan provide for a repayment period of not more than five years (except for a loan specifically to purchase a home) and for level amortization of loan payments with payments not less frequently than quarterly.³⁰⁵ Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan.

A plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount of the employee's account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

New Federal Law (IRC section 402)

Under the provision, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. A qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a IRC section 403(b) plan or a governmental IRC section 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from

³⁰⁴Treasury Regulation sections 1.402(c)-2, QA-1(b)(3).

³⁰⁵ IRC section 72(p).

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employment. As under present law, a loan offset amount under the provision is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan.

Effective Dates

The provision is effective for plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

California Law (R&TC section 17501 and 24601)

California conforms, under the PITL and the CTL, by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), in R&TC sections 17501 and 24601.

However, R&TC sections 17501(b) and 24601(b) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC sections 17024.5 and 23051.5.

Thus, the federal extended rollover period for plan loan offset amounts automatically applies under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

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Part VIII—Exempt Organizations

<u>Section</u>	<u>Section Title</u>
13701	Excise Tax Based on Investment Income of Private Colleges and Universities

Background

Public Charities and Private Foundations

An organization qualifying for tax-exempt status under IRC section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.³⁰⁶ Certain organizations are classified as public charities per se, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.³⁰⁷ Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.³⁰⁸ Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (e.g., fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.³⁰⁹ A supporting organization, i.e., an organization that provides support to another IRC section 501(c)(3) entity that is not a private foundation and meets the requirements of the IRC, also is classified as a public charity.³¹⁰

³⁰⁶ The IRC does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

³⁰⁷ IRC section 509(a)(1) (referring to IRC sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

³⁰⁸ Treasury Regulation sections 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a “facts and circumstances” test. Treasury Regulation sections 1.170A-9(f)(3).

³⁰⁹ To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. IRC section 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under IRC section 512 over the amount of unrelated business income tax imposed by IRC section 511. IRC section 509(a)(2)(B).

³¹⁰ IRC section 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (i.e., *per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations. Organizations organized and operated exclusively for testing for public safety also are classified as public charities. IRC section 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under IRC section 170.

An IRC section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (e.g., an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities.³¹¹

Excise Tax on Investment Income of Private Foundations

Under IRC section 4940(a), private foundations that are recognized as exempt from Federal income tax under IRC section 501(a) (other than exempt operating foundations)³¹² are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)³¹³ equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.³¹⁴ In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in IRC section 4942.

³¹¹ Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). IRC section 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (IRC section 4941), are required to make a minimum amount of charitable distributions each year, (IRC section 4942), are limited in the extent to which they may control a business (IRC section 4943), may not make speculative investments (IRC section 4944), and may not make certain expenditures (IRC section 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

³¹² Exempt operating foundations are exempt from the IRC section 4940 tax. IRC section 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in IRC section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. IRC section 4940(d)(2).

³¹³ IRC section 4942(g).

³¹⁴ IRC section 4940(e).

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Private foundations that are not exempt from tax under IRC section 501(a), such as certain charitable trusts, are subject to an excise tax under IRC section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under IRC section 4940(a) if the foundation were tax-exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax-exempt, over the income tax imposed on the foundation under subtitle A of the IRC.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under IRC section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under IRC section 4942 is reduced by the amount of IRC section 4940 excise taxes paid.³¹⁵

Private Colleges and Universities

Private colleges and universities generally are treated as public charities rather than private foundations³¹⁶ and thus are not subject to the private foundation excise tax on net investment income.

New Federal Law (IRC section 4968)

The provision imposes an excise tax on an applicable educational institution for each taxable year equal to 1.4 percent of the net investment income of the institution for the taxable year. Net investment income is determined using rules similar to the rules of IRC section 4940(c) (relating to the net investment income of a private foundation).

For purposes of the provision, an applicable educational institution is an institution: (1) that has at least 500 students during the preceding taxable year; (2) that is an eligible education institution as described in section 25A of the IRC;³¹⁷ (3) that is not described in the first section of section 511(a)(2)(B) of the IRC (generally describing State colleges and universities); (4) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purpose³¹⁸) is at least \$500,000 per student; and (5) more than 50 percent of the students of which are located in the United States. For this purpose, the number of students at a location is based on the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis.

³¹⁵ IRC section 4942(d)(2).

³¹⁶ IRC sections 509(a)(1) and 170(b)(1)(A)(ii).

³¹⁷ IRC section 25A defines an eligible educational institution as an institution (1) which is described in IRC section 481 of the Higher Education Act of 1965 (20 U.S.C. section 1088), as in effect on August 5, 1977, and (2) which is eligible to participate in a program under title IV of such Act.

³¹⁸ Assets used directly in carrying out the institution's exempt purpose include, for example, classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets.

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For purposes of determining whether an institution meets the asset-per-student threshold and determining net investment income, assets and net investment income include amounts with respect to an organization that is related to the institution. An organization is treated as related to the institution for this purpose if the organization: (1) controls, or is controlled by, the institution; (2) is controlled by one or more persons that control the institution; or (3) is a supported organization³¹⁹ or a supporting organization³²⁰ during the taxable year with respect to the institution. In addition, (1) no such amount is taken into account with respect to more than one educational institution; and (2) unless the related organization is controlled by the educational institution or is a supporting organization (described in IRC section 509(a)(3)) with respect to the institution for the taxable year, assets and investment income that are not intended or available for the use or benefit of the educational institution are not taken into account. For example, assets of a related organization that are earmarked or restricted for (or fairly attributable to) the educational institution would be treated as assets of the educational institution, whereas assets of a related organization that are held for unrelated purposes (and are not fairly attributable to the educational institution) would be disregarded.

The Secretary shall promulgate regulations to carry out the intent of the provision, including regulations that describe: (1) assets that are used directly in carrying out the educational institution's exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of the educational institution.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

³¹⁹ IRC section 509(f)(3).

³²⁰ IRC section 509(a)(3).

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<u>Section</u>	<u>Section Title</u>
13702	Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity

Background

Tax Exemption for Certain Organizations

IRC section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in IRC section 501(c) (including among others IRC section 501(c)(3) charitable organizations and IRC section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in IRC section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in IRC section 401(a).

Unrelated Business Income Tax, In General

An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (e.g., program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization's unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.³²¹

The unrelated business income tax (UBIT) generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.³²² An organization that is subject to UBIT and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. An IRC section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.³²³ Therefore, the unrelated trade or business activity of an IRC section 501(c)(3) organization must be insubstantial.

³²¹ This is the case for social clubs (IRC section 501(c)(7)), voluntary employees' beneficiary associations (IRC section 501(c)(9)), and organizations and trusts described in IRC sections 501(c)(17) and 501(c)(20). IRC section 512(a)(3).

³²² IRC sections 511-514.

³²³ Treasury Regulation sections 1.501(c)(3)-1(e).

Organizations Subject to Tax on Unrelated Business Income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under IRC section 501(a), including organizations described in IRC section 501(c) (except for U.S. instrumentalities and certain charitable trusts);³²⁴ (2) qualified pension, profit-sharing, and stock bonus plans described in IRC section 401(a);³²⁵ and (3) certain State colleges and universities.³²⁶

Exclusions from Unrelated Business Taxable Income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,³²⁷ unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.³²⁸ Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for AMT determined after taking into account adjustments and tax preference items.

Specific Deduction against Unrelated Business Taxable Income

In computing unrelated business taxable income, an exempt organization may take a specific deduction of \$1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.³²⁹

In the case of a diocese, province or religious order, or a convention or association of churches, a specific deduction is allowed with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of \$1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.³³⁰

³²⁴ IRC section 511(a)(2)(A).

³²⁵ IRC section 511(a)(2)(A).

³²⁶ IRC section 511(a)(2)(B).

³²⁷ IRC sections 511-514.

³²⁸ IRC section 512(b)(13).

³²⁹ IRC section 512(b)(12).

³³⁰ Ibid.

Operation of Multiple Unrelated Trades or Businesses

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business.³³¹ Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions.³³² As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

New Federal Law (IRC section 512)

For an organization with more than one unrelated trade or business, the provision requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under IRC section 512(b)(12). The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under IRC section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the provision is that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year. The provision generally does not, however, prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017. Under a special transition rule, net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date, are not subject to the general rule of the provision.

California Law (IRC section 23732)

California conforms, under the CTL, to the federal rules that apply to “unrelated business taxable income” under IRC section 512, as of the “specified date” of January 1, 2015,³³³ with modifications, but does not conform to the requirement that “unrelated business taxable income” be separately computed for each trade or business activity.

³³¹ IRC section 512(a).

³³² Treasury Regulation sections 1.512(a)-1(a).

³³³ R&TC section 23051.5.

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Impact on California Revenue

Estimated Conformity Revenue Impact of Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	\$12,000,000	\$11,000,000	\$10,000,000

<u>Section</u>	<u>Section Title</u>
13703	Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction is Disallowed

Background

Tax Exemption for Certain Organizations

IRC section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in IRC section 501(c) (including among others IRC section 501(c)(3) charitable organizations and IRC section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in IRC section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in IRC section 401(a).

Unrelated Business Income Tax, In General

The unrelated business income tax (“UBIT”) generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.³³⁴ An organization that is subject to UBIT and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing its exempt status. An IRC section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.³³⁵ Therefore, the unrelated trade or business activity of an IRC section 501(c)(3) organization must be insubstantial.

³³⁴ IRC sections 511-514.

³³⁵ Treasury Regulation sections 1.501(c)(3)-1(e).

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business.³³⁶ Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions.³³⁷ As a result, an organization may use a loss from one unrelated trade or business to offset gain from another, thereby reducing total unrelated business taxable income.

Organizations Subject to Tax on Unrelated Business Income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under IRC section 501(a), including organizations described in IRC section 501(c) (except for U.S. instrumentalities and certain charitable trusts); (2) qualified pension, profit-sharing, and stock bonus plans described in IRC section 401(a); and (3) certain State colleges and universities.³³⁸

Exclusions from Unrelated Business Taxable Income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,³³⁹ unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.³⁴⁰ Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for AMT determined after taking into account adjustments and tax preference items.

New Federal Law (IRC section 512)

Under the provision, unrelated business taxable income includes any expenses paid or incurred by a tax-exempt organization for qualified transportation fringe benefits (as defined in IRC section 132(f)), a parking facility used in connection with qualified parking (as defined in IRC section 132(f)(5)(C)), or any on-premises athletic facility (as defined in IRC section 132(j)(4)(B)), provided such amounts are not deductible under IRC section 274.

³³⁶ IRC section 512(a).

³³⁷ Treasury Regulation sections 1.512(a)-1(a).

³³⁸ IRC section 511(a)(2).

³³⁹ IRC section 511-514.

³⁴⁰ IRC section 512(b)(13).

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Effective Dates

The provision is effective for amounts paid or incurred after December 31, 2017.

California Law (IRC section 17201, 23732, and 24443)

California conforms, under the PITL and the CTL, to the federal rules that apply to the disallowance of certain entertainment, etc., expenses under IRC section 274, as of the “specified date” of January 1, 2015.³⁴¹

California also conforms, under the PITL, to the federal rules that apply to “unrelated business taxable income” under IRC section 512 as of the “specified date” of January 1, 2015, with modifications, but does not conform to the change increasing “unrelated business taxable income” by the amount of certain fringe benefit expenses for which a deduction is disallowed.

Impact on California Revenue

Estimated Conformity Revenue Impact of Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction is Disallowed For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
See above Section 13304	See above Section 13304	See above Section 13304	See above Section 13304

Section

Section Title

13704 Repeal of Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights

Background

In General

The IRC allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, Federal, State, local, and Indian tribal governments, and certain other organizations.

³⁴¹ R&TC section 17024.5 and 23051.5.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in IRC section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.³⁴² Fourth, the transfer must be of money or property—contributions of services are not deductible.³⁴³ Finally, the transfer must be substantiated and in the proper form.

As discussed below, special rules limit the deductibility of a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

Contributions of Partial Interests in Property

In General

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.³⁴⁴ This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.³⁴⁵ For this purpose, a future interest is one “in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization that has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property.”³⁴⁶

³⁴² IRC section 170(a)(1).

³⁴³ For example, as discussed in greater detail below, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

³⁴⁴ IRC sections 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

³⁴⁵ IRC section 170(a)(3).

³⁴⁶ Treasury Regulation sections 1.170A-5(a)(4). Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has “no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year.” Treasury Regulation sections 1.170A-5(a)(2).

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A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.³⁴⁷ For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.³⁴⁸ A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.³⁴⁹

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

Qualified Conservation Contributions

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.³⁵⁰ A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Percentage Limits on Charitable Contributions

Individual Taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's AGI for a taxable year, disregarding any net operating loss carryback to the year under IRC section 172.³⁵¹ In general,

³⁴⁷ IRC section 170(f)(3)(B)(ii).

³⁴⁸ Treasury Regulation sections 1.170A-7(b)(1).

³⁴⁹ Treasury Regulation sections 1.170A-7(b)(1).

³⁵⁰ IRC sections 170(f)(3)(B)(iii) and 170(h).

³⁵¹ IRC section 170(b)(1)(G).

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more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in IRC section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

Contributions of appreciated capital gain property to public charities and other organizations described in IRC section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in IRC section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.³⁵² Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

³⁵² *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).

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TABLE 3.—CHARITABLE CONTRIBUTION PERCENTAGE LIMITS FOR INDIVIDUAL TAXPAYERS³⁵³

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient ³⁵⁴	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30% ³⁵⁵	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate Taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.³⁵⁶ For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.³⁵⁷

Carryforwards of Excess Contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.³⁵⁸ In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Qualified Conservation Contributions

Preferential percentage limits and carryforward rules apply for qualified conservation contributions.³⁵⁹ In general, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an

³⁵³ Percentages shown are the percentage of an individual's contribution base.

³⁵⁴ Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

³⁵⁵ Certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.

³⁵⁶ IRC section 170(b)(2)(A).

³⁵⁷ IRC section 170(b)(2)(C).

³⁵⁸ IRC section 170(d).

³⁵⁹ IRC section 170(b)(1)(E).

organization described in IRC section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under IRC section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.³⁶⁰

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of IRC section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Valuation of Charitable Contributions

In General

For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of the property, the donor's tax basis in the property, or in some cases a different amount.

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair market value of long-term capital gain property contributed to charity.³⁶¹ Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, IRC section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;³⁶² (2) contributions of tangible personal

³⁶⁰ IRC section 170(b)(2)(B).

³⁶¹ Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. IRC section 170(e)(1)(A).

³⁶² IRC section 170(e). Special rules, discussed below, apply for certain contributions of inventory and other property.

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property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;³⁶³ and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).³⁶⁴

For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value.³⁶⁵ Qualified appreciated stock is stock that is capital gain property and for which (as of the date of the contribution) market quotations are readily available on an established securities market.³⁶⁶ A contribution of qualified appreciated stock (when increased by the aggregate amount of all prior such contributions by the donor of stock in the corporation) generally does not include a contribution of stock to the extent the amount of the stock contributed exceeds 10 percent (in value) of all of the outstanding stock of the corporation.³⁶⁷

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

Enhanced Deduction Rules for Certain Contributions of Inventory and Other Property

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain statutorily described contributions of appreciated inventory and other property qualify for an enhanced deduction valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.³⁶⁸ To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in IRC section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.³⁶⁹ Contributions to organizations that are not described in IRC section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.

³⁶³ IRC section 170(e)(1)(B)(i)(I).

³⁶⁴ IRC section 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. IRC section 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.

³⁶⁵ IRC section 170(e)(5).

³⁶⁶ IRC section 170(e)(5)(B).

³⁶⁷ IRC section 170(e)(5)(C).

³⁶⁸ IRC section 170(e)(3).

³⁶⁹ IRC section 170(e)(3)(A)(i)-(iii).

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To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

A taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.³⁷⁰

Selected Statutory Rules for Specific Types of Contributions

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles, intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report—and in many instances overstated—the value of the property for purposes of claiming a charitable deduction.

Vehicle Donations.—Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds \$500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and Other Intellectual Property.—If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory)³⁷¹ to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.³⁷² In addition, the taxpayer generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).³⁷³

Clothing and Household Items.—Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the

³⁷⁰ IRC section 170(e)(3)(C).

³⁷¹ Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See IRC section 1221(a)(3), 1231(b)(1)(C).

³⁷² IRC section 170(e)(1)(B)(iii).

³⁷³ The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization. Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than \$500 may be deducted if the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.³⁷⁴ Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.³⁷⁵

College athletic seating rights.—In general, where a taxpayer receives or expects to receive a substantial return benefit for a payment to charity, the payment is not deductible as a charitable contribution. However, special rules apply to certain payments to institutions of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. Specifically, the payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is paid to or for the benefit of an institution of higher education (as defined in IRC section 3304(f)) described in IRC section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and meeting certain other requirements), and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.³⁷⁶

Use of a Vehicle When Volunteering for a Charity

Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may qualify as a charitable contribution.³⁷⁷ No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.³⁷⁸

³⁷⁴ As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than \$5,000.

³⁷⁵ The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.

³⁷⁶ IRC section 170(l).

³⁷⁷ Treasury Regulation sections 1.170A-1(g).

³⁷⁸ IRC section 170(j).

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In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may track and deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile.³⁷⁹ The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.³⁸⁰

Substantiation and Other Formal Requirements

In General

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.³⁸¹ In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.³⁸²

³⁷⁹ IRC section 170(i).

³⁸⁰ In lieu of actual operating expenses, an optional standard mileage rate may be used in computing deductible transportation expenses for medical purposes (IRC section 213) or for work-related moving (IRC section 217). The standard mileage rates for medical and moving purposes generally cover only out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile. Such rates do not include costs that are not deductible for medical or moving purposes, such as general maintenance expenses, depreciation, insurance, and registration fees. The medical and moving standard mileage rates are determined by the IRS and updated periodically. For expenses paid or incurred on or after January 1, 2017, the rate for both such purposes is 17 cents per mile. IRS Notice 2016-79.

³⁸¹ IRC section 170(f)(17).

³⁸² Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services. IRC section 170(f)(8).

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In addition, any charity receiving a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.³⁸³

If the total charitable deduction claimed for noncash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.³⁸⁴ In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.

Exception for Certain Contributions Reported by the Donee Organization

IRC subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. “[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished.”³⁸⁵ No such final regulations have been issued.³⁸⁶

New Federal Law (IRC section 170)

The provision amends IRC section 170(l) to provide that no charitable deduction shall be allowed for any amount described in paragraph 170(l)(2), generally a payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event, as described in greater detail above.

Effective Dates

The provisions is effective for contributions made in taxable years beginning after December 31, 2017.

³⁸³ IRC section 6115.

³⁸⁴ IRC section 170(f)(11).

³⁸⁵ See IRS, Notice of Proposed Rulemaking, Substantiation Requirement for Certain Contributions, REG-138344-13 (October 13, 2015), I.R.B. 2015-41 (preamble).

³⁸⁶ In October 2015, the IRS issued proposed regulations that, if finalized, would have implemented the IRC section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement. The proposed regulations provided that a return filed by a donee organization under IRC section 170(f)(8)(D) must include, in addition to the information generally required on a contemporaneous written acknowledgment: (1) the name and address of the donee organization; (2) the name and address of the donor; and (3) the taxpayer identification number of the donor. In addition, the return must be filed with the IRS (with a copy provided to the donor) on or before February 28 of the year following the calendar year in which the contribution was made. Under the proposed regulations, donee reporting would have been optional and would have been available solely at the discretion of the donee organization. The proposed regulations were withdrawn in January 2016. See Prop. Treas. Reg. sec. 1.170A-13(f)(18).

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California Law (R&TC sections 17201, 24357 – 24359.1)

California conforms, under the PITL, to the federal charitable contribution rules under IRC section 170 as of the “specified date” of January 1, 2015,³⁸⁷ with modifications, but does not conform to the repeal of the deduction for amounts paid in exchange for college athletic event seating rights.

Under the CTL, California does not conform to IRC section 170, but instead has stand-alone law that is generally similar to federal law allowing corporations a deduction for charitable contributions.³⁸⁸ R&TC section 24357.10 provides that if an amount is paid to or for the benefit of a school or university and such amount would be deductible as a charitable contribution except for the fact that the taxpayer is given the right to buy tickets for seating at an athletic event in the institution's stadium, 80 percent of the contribution will be allowed as charitable contribution. The deductible amount does not include the portion of the contribution representing the actual cost of the tickets.

As a result, California does not conform to the repeal of the deduction for amounts paid in exchange for college athletic event seating rights.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	\$5,100,000	\$2,700,000	\$2,700,000

Section

Section Title

13705 Repeal of Substantiation Exception in Case of Contributions Reported by Donee

Background

In General

The IRC allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, Federal, State, local, and Indian tribal governments, and certain other organizations.

³⁸⁷ R&TC section 17024.5.

³⁸⁸ R&TC sections 24357 – 24359.1.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in IRC section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.³⁸⁹ Fourth, the transfer must be of money or property—contributions of services are not deductible.³⁹⁰ Finally, the transfer must be substantiated and in the proper form.

As discussed below, special rules limit the deductibility of a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

Contributions of Partial Interests in Property

In General

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.³⁹¹ This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.³⁹² For this purpose, a future interest is one “in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization that has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property.”³⁹³

³⁸⁹ IRC section 170(a)(1).

³⁹⁰ For example, as discussed in greater detail below, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

³⁹¹ IRC sections 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

³⁹² IRC section 170(a)(3).

³⁹³ Treasury Regulation sections 1.170A-5(a)(4). Treasury regulations provide that IRC section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has “no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year.” Treasury Regulation sections 1.170A-5(a)(2).

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A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.³⁹⁴ For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.³⁹⁵ A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.³⁹⁶

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

Qualified Conservation Contributions

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.³⁹⁷ A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Percentage Limits on Charitable Contributions

Individual Taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's AGI for a taxable year, disregarding any net operating loss carryback to the year under IRC section 172.³⁹⁸ In general,

³⁹⁴ IRC section 170(f)(3)(B)(ii).

³⁹⁵ Treasury Regulation sections 1.170A-7(b)(1).

³⁹⁶ Treasury Regulation sections 1.170A-7(b)(1).

³⁹⁷ IRC sections 170(f)(3)(B)(iii) and 170(h).

³⁹⁸ IRC section 170(b)(1)(G).

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more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in IRC section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50-percent limitation.

Contributions of appreciated capital gain property to public charities and other organizations described in IRC section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30-percent limitation.

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in IRC section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.³⁹⁹ Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

³⁹⁹ *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).

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TABLE 3.—CHARITABLE CONTRIBUTION PERCENTAGE LIMITS FOR INDIVIDUAL TAXPAYERS⁴⁰⁰

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient ⁴⁰¹	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30% ⁴⁰²	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate Taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.⁴⁰³ For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.⁴⁰⁴

Carryforwards of Excess Contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.⁴⁰⁵ In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Qualified Conservation Contributions

Preferential percentage limits and carryforward rules apply for qualified conservation contributions.⁴⁰⁶ In general, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an

⁴⁰⁰ Percentages shown are the percentage of an individual's contribution base.

⁴⁰¹ Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

⁴⁰² Certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.

⁴⁰³ IRC section 170(b)(2)(A).

⁴⁰⁴ IRC section 170(b)(2)(C).

⁴⁰⁵ IRC section 170(d).

⁴⁰⁶ IRC section 170(b)(1)(E).

organization described in IRC section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under IRC section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.⁴⁰⁷

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of IRC section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Valuation of Charitable Contributions

In General

For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of the property, the donor's tax basis in the property, or in some cases a different amount.

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair market value of long-term capital gain property contributed to charity.⁴⁰⁸ Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, IRC section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;⁴⁰⁹ (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt

⁴⁰⁷ IRC section 170(b)(2)(B).

⁴⁰⁸Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. IRC section 170(e)(1)(A).

⁴⁰⁹ IRC section 170(e). Special rules, discussed below, apply for certain contributions of inventory and other property.

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purpose;⁴¹⁰ and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).⁴¹¹

For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value.⁴¹² Qualified appreciated stock is stock that is capital gain property and for which (as of the date of the contribution) market quotations are readily available on an established securities market.⁴¹³ A contribution of qualified appreciated stock (when increased by the aggregate amount of all prior such contributions by the donor of stock in the corporation) generally does not include a contribution of stock to the extent the amount of the stock contributed exceeds 10 percent (in value) of all of the outstanding stock of the corporation.⁴¹⁴

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

Enhanced Deduction Rules for Certain Contributions of Inventory and Other Property

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain statutorily described contributions of appreciated inventory and other property qualify for an enhanced deduction valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.⁴¹⁵ To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in IRC section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.⁴¹⁶ Contributions to organizations that are not described in IRC section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.

⁴¹⁰ IRC section 170(e)(1)(B)(i)(I).

⁴¹¹ IRC section 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. IRC section 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.

⁴¹² IRC section 170(e)(5).

⁴¹³ IRC section 170(e)(5)(B).

⁴¹⁴ IRC section 170(e)(5)(C).

⁴¹⁵ IRC section 170(e)(3).

⁴¹⁶ IRC section 170(e)(3)(A)(i)-(iii).

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To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

A taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.⁴¹⁷

Selected Statutory Rules for Specific Types of Contributions

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles, intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report—and in many instances overstated—the value of the property for purposes of claiming a charitable deduction.

Vehicle Donations.—Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds \$500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and Other Intellectual Property.—If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory)⁴¹⁸ to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.⁴¹⁹ In addition, the taxpayer generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).⁴²⁰

Clothing and Household Items.—Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the

⁴¹⁷ IRC section 170(e)(3)(C).

⁴¹⁸ Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See IRC section 1221(a)(3), 1231(b)(1)(C).

⁴¹⁹ IRC section 170(e)(1)(B)(iii).

⁴²⁰ The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization. Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than \$500 may be deducted if the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.⁴²¹ Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.⁴²²

Use of a Vehicle When Volunteering for a Charity

Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may qualify as a charitable contribution.⁴²³ No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.⁴²⁴

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may track and deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile.⁴²⁵ The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the

⁴²¹ As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than \$5,000.

⁴²² The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.

⁴²³ Treasury Regulation sections 1.170A-1(g).

⁴²⁴ IRC section 170(j).

⁴²⁵ IRC section 170(i).

charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.⁴²⁶

Substantiation and Other Formal Requirements

In General

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.⁴²⁷ In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.⁴²⁸

In addition, any charity receiving a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.⁴²⁹

If the total charitable deduction claimed for noncash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.⁴³⁰ In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.

⁴²⁶ In lieu of actual operating expenses, an optional standard mileage rate may be used in computing deductible transportation expenses for medical purposes (IRC section 213) or for work-related moving (IRC section 217). The standard mileage rates for medical and moving purposes generally cover only out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile. Such rates do not include costs that are not deductible for medical or moving purposes, such as general maintenance expenses, depreciation, insurance, and registration fees. The medical and moving standard mileage rates are determined by the IRS and updated periodically. For expenses paid or incurred on or after January 1, 2017, the rate for both such purposes is 17 cents per mile. IRS Notice 2016-79.

⁴²⁷ IRC section 170(f)(17).

⁴²⁸ Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services. IRC section 170(f)(8).

⁴²⁹ IRC section 6115.

⁴³⁰ IRC section 170(f)(11).

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Exception for Certain Contributions Reported by the Donee Organization

IRC subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. “[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished.”⁴³¹ No such final regulations have been issued.⁴³²

New Federal Law (IRC section 170)

The provision repeals the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement.

Effective Dates

The provision is effective for contributions made in taxable years beginning after December 31, 2016.

California Law (R&TC sections 17201, 17275.5, and 24357)

California conforms under the PITL, to the federal charitable contribution rules under IRC section 170 as of the “specified date” of January 1, 2015,⁴³³ with modifications. Additionally, California law⁴³⁴ provides that upon a showing that the federal substantiation requirements are met for a particular contribution, a deduction will not be denied for California purposes.

As a result, California does not conform to the repeal of the exception to the contemporaneous written acknowledgment requirement.

⁴³¹ See IRS, Notice of Proposed Rulemaking, Substantiation Requirement for Certain Contributions, REG-138344-13 (October 13, 2015), I.R.B. 2015-41 (preamble).

⁴³² In October 2015, the IRS issued proposed regulations that, if finalized, would have implemented the IRC section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement. The proposed regulations provided that a return filed by a donee organization under IRC section 170(f)(8)(D) must include, in addition to the information generally required on a contemporaneous written acknowledgment: (1) the name and address of the donee organization; (2) the name and address of the donor; and (3) the taxpayer identification number of the donor. In addition, the return must be filed with the IRS (with a copy provided to the donor) on or before February 28 of the year following the calendar year in which the contribution was made. Under the proposed regulations, donee reporting would have been optional and would have been available solely at the discretion of the donee organization. The proposed regulations were withdrawn in January 2016. See Prop. Treas. Reg. sec. 1.170A-13(f)(18).

⁴³³ R&TC section 17024.5.

⁴³⁴ R&TC section 17275.5.

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Under the CTL, California does not conform to IRC section 170, but instead has stand-alone law that is generally similar to federal law allowing corporations a deduction for charitable contributions.⁴³⁵ However, R&TC section 24357 specifically conforms to paragraph (8) of subdivision (f) of IRC section 170, relating to the contemporaneous written acknowledgment requirement and to the exception, as of the “specified date” of January 1, 2015.⁴³⁶

As a result, California does not conform to the repeal of the exception to the contemporaneous written acknowledgment requirement.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Substantiation Exception in Case of Contributions Reported by Donee For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	Negligible	Negligible	Negligible

⁴³⁵ R&TC sections 24357 – 24359.1.

⁴³⁶ R&TC section 23051.5.

Part IX—Other Provisions

Subpart A—Craft Beverage Modernization and Tax Reform

<u>Section</u>	<u>Section Title</u>
13801	Production Period for Beer, Wine, and Distilled Spirits

Background

In General

The uniform capitalization (UNICAP) rules, which were enacted as part of the Tax Reform Act of 1986,⁴³⁷ require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.⁴³⁸ For real or personal property acquired by the taxpayer for resale, IRC section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property's production period⁴³⁹ and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding two years, or (3) has an estimated production period exceeding one year and a cost exceeding \$1,000,000.⁴⁴⁰ The production period with respect to any property is the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or held for sale.⁴⁴¹ In the case of property that is customarily aged (e.g., tobacco, wine, and whiskey) before it is sold, the production period includes the aging period.⁴⁴²

⁴³⁷ IRC section 803(a) of Pub. L. No. 99-514 (1986).

⁴³⁸ IRC section 263A.

⁴³⁹ See Treasury Regulation sections 1.263A-12.

⁴⁴⁰ IRC section 263A(f).

⁴⁴¹ IRC section 263A(f)(4)(B).

⁴⁴² See Treasury Regulation sections 1.263A-12(d)(1). See also TAM 9327007 (Mar. 31, 1993) (holding that producers of wine must include the time that wine ages in bottles as part of the production period, which concludes when the wine vintage is officially released to the distribution chain).

Exceptions from UNICAP

IRC section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have \$10 million or less of average annual gross receipts for the preceding three-taxable year period;⁴⁴³ such taxpayers are not required to include additional IRC section 263A costs in inventory.

Another exception exists for taxpayers who raise, harvest, or grow trees.⁴⁴⁴ Under this exception, IRC section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any animal or plant having a reproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under IRC section 447 or 448(a)(3)).⁴⁴⁵

Freelance authors, photographers, and artists also are exempt from IRC section 263A for any qualified creative expenses.⁴⁴⁶ Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.

New Federal Law (IRC section 263A)

The provision excludes the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus, under the provision, producers of beer, wine and distilled spirits are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period.

Effective Dates

The provision is effective for interest costs paid or accrued in calendar years beginning after December 31, 2017, and does not apply to interest costs paid or accrued after December 31, 2019.

⁴⁴³ IRC section 263A(b)(2)(B). No statutory exception is available for small taxpayers who produce property subject to IRC section 263A. However, a *de minimis* rule under Treasury regulations treats producers that use the simplified production method and incur total indirect costs of \$200,000 or less in a taxable year as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treasury Regulation sections 1.263A-2(b)(3)(iv). However, the Chairman's Mark of the "Tax Cuts and Jobs Act" proposes to expand the exception for small taxpayers from the uniform capitalization rules. Under the provision, any producer or reseller that meets the \$15 million gross receipts test is exempted from the application of IRC section 263A. See section III.B.4 of *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017.

⁴⁴⁴ IRC section 263A(c)(5).

⁴⁴⁵ IRC section 263A(d). See also section III.B.3 of *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017, which expands the universe of farming C corporations that may use the cash method to include any farming C corporation that meets the \$15 million gross receipts test.

⁴⁴⁶ IRC section 263A(h).

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California Law (R&TC sections 17201 and 24422.3)

California conforms, under the PITL and CTL, to the federal rules for capitalization and inclusion in inventory for costs of certain expenses, also known as the UNICAP rules, under IRC section 263A, as of the “specified date” of January 1, 2015,⁴⁴⁷ but does not conform to the exception to the UNICAP rules for the allocation of interest for the production period for beer, wine, and distilled spirits.

Impact on California Revenue

Estimated Conformity Revenue Impact of Production Period for Beer, Wine, and Distilled Spirits For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- \$4,100,000	- \$2,100,000	- \$700,000

<u>Section</u>	<u>Section Title</u>
13802	Reduced Rate of Excise Tax on Beer

Background

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the FTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the CBP) of the Department of Homeland Security (under delegation by the Secretary of the Treasury).

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

⁴⁴⁷ R&TC section 17024.5 and 23051.5.

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The rate of tax on beer is \$18 per barrel (31 gallons).⁴⁴⁸ Small brewers are subject to a reduced tax rate of \$7 per barrel on the first 60,000 barrels of beer domestically produced and removed each year.⁴⁴⁹ Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

In the case of a controlled group, the two million barrel limitation for small brewers is applied to the controlled group, and the 60,000 barrels eligible for the reduced rate of tax, are apportioned among the brewers who are component members of such group. The term “controlled group” has the meaning assigned to it by IRC section 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

New Federal Law (IRC section 5051)

The provision lowers the rate of tax on beer to \$16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. In general, in the case of a controlled group of brewers, the six million barrel limitation is applied and apportioned at the level of the controlled group. Beer brewed or imported in excess of the six million barrel limit would continue to be taxed at \$18 per barrel. In the case of small brewers, such brewers would be taxed at a rate of \$3.50 per barrel on the first 60,000 barrels domestically produced, and \$16 per barrel on any further barrels produced. The same rules applicable to controlled groups under present law apply with respect to this limitation.

For barrels of beer that have been brewed or produced outside of the United States and imported into the United States, the reduced tax rate may be assigned by the brewer to any importer of such barrels pursuant to requirements set forth by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of barrels of beer for which the reduced tax rate has been assigned by a brewer to any importer does not exceed the number of barrels of beer brewed or produced by such brewer during the calendar year which were imported into the United States by such importer; (2) procedures that allow a brewer and an importer to elect whether to receive the reduced tax rate; (3) requirements that the brewer provide any information as the Secretary of the Treasury determines necessary and appropriate for purposes of assignment of the reduced tax rate; and (4) procedures that allow for revocation of eligibility of the brewer and the importer for the reduced tax rate in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

⁴⁴⁸ IRC section 5051.

⁴⁴⁹ IRC section 5051(a)(2).

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Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of IRC section 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).⁴⁵⁰

Under rules issued by the Secretary of the Treasury, two or more entities (whether or not under common control) that produce beer marketed under a similar brand, license, franchise, or other arrangement shall be treated as a single taxpayer for purposes of the excise tax on beer.

Effective Dates

The provision is effective for beer removed after December 31, 2017.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

<u>Section</u>	<u>Section Title</u>
13803	Transfer of Beer between Bonded Facilities

Background

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the FTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the CBP) of the Department of Homeland Security (under delegation by the Secretary of the Treasury). The rate of tax on beer is \$18 per barrel (31 gallons).⁴⁵¹

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of

⁴⁵⁰ Members of the controlled group may include foreign corporations.

⁴⁵¹ IRC section 5051.

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tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Small domestic brewers are subject to a reduced tax rate of \$7 per barrel on the first 60,000 barrels of beer removed each year.⁴⁵² Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer. Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Transfer Rules and Removals without Tax

Certain removals or transfers of beer are exempt from tax. Beer may be transferred without payment of the tax between bonded premises under certain conditions specified in the regulations.⁴⁵³ The tax liability accompanies the beer that is transferred in bond. However, beer may only be transferred free of tax between breweries if both breweries are owned by the same brewer.

New Federal Law (IRC section 5414)

The provision relaxes the shared ownership requirement of IRC section 5414. Thus, under the provision, a brewer may transfer beer from one brewery to another without incurring tax, provided that: (i) the breweries are owned by the same person; (ii) one brewery owns a controlling interest in the other; (iii) the same person or persons have a controlling interest in both breweries; or (iv) the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of the tax.

For purposes of transferring the tax liability pursuant to (iv) above, such relief from liability shall be effective from the time of removal from the transferor's bonded premises, or from the time of divestment, whichever is later.

Effective Dates

The provision applies to any calendar quarters beginning after December 31, 2017, and does not apply for calendar quarters beginning after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

⁴⁵² IRC section 5051(a)(2).

⁴⁵³ IRC section 5414.

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Impact on California Revenue

The FTB does not administer these types of excise taxes.

<u>Section</u>	<u>Section Title</u>
13804	Reduced Rate of Excise Tax on Certain Wine

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (IRC section 5041)	
“Still wines” ⁴⁵⁴ not more than 14 percent alcohol	\$1.07 per wine gallon
“Still wines” more than 14 percent, but not more than 21 percent, alcohol.	\$1.57 per wine gallon
“Still wines” more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
“Still wines” more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced Rates and Exemptions for Certain Wine Producers

Wineries having aggregate annual production not exceeding 250,000 gallons (“small domestic producers”) receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.⁴⁵⁵ The credit is reduced (but not below zero) by

⁴⁵⁴ A “still wine” is a non-sparkling wine. Most common table wines are still wines.

⁴⁵⁵ IRC section 5041(c).

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one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term “controlled group” has the meaning assigned to it by IRC section 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single adult households.

New Federal Law (IRC section 5041)

The provision modifies the credit against the wine excise tax for small domestic producers, by removing the 250,000 wine gallon domestic production limitation (and thus making the credit available for all wine producers and importers). Additionally, under the provision, sparkling wine producers and importers are now eligible for the credit. With respect to wine produced in, or imported into, the United States during a calendar year, the credit amount is (1) \$1.00 per wine gallon for the first 30,000 wine gallons of wine, plus; (2) 90 cents per wine gallon on the next 100,000 wine gallons of wine, plus; (3) 53.5 cents per wine gallon on the next 620,000 wine gallons of wine.⁴⁵⁶ There is no phase-out of the credit.

In the case of any wine gallons of wine that have been produced outside of the United States and imported into the United States, the tax credit allowable may be assigned by the person who produced such wine (the “foreign producer”) to any electing importer of such wine gallons pursuant to requirements established by the Secretary of the Treasury, in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of wine gallons of wine for which the tax credit has been assigned by a foreign producer to any importer does not exceed the number of wine gallons of wine produced by such foreign producer, during the calendar year, which were imported into the United States by such importer; (2) procedures that allow the election of a foreign producer to assign, and an importer to receive, the tax credit; (3) requirements that the foreign producer provide any information that the Secretary of the Treasury determines to be necessary and appropriate for purposes of assigning the tax credit; and (4) procedures that allow for revocation of eligibility of the foreign producer and the importer for the tax credit in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

⁴⁵⁶ The credit rate for hard cider is tiered at the same level of production or importation, but is equal to 6.2 cents, 5.6 cents and 3.3 cents, respectively.

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Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the winemaker, within the meaning of IRC section 1563(a), except that the phrase “more than 50 percent” is substitute for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).⁴⁵⁷

Effective Dates

The provision applies to wine removed after December 31, 2017, and does not apply for wine removed in calendar quarters beginning after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Section

Section Title

13805 Adjustment of Alcohol Content Level for Application of Excise Tax Rates

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (IRC section 5041)	
“Still wines” ⁴⁵⁸ not more than 14 percent alcohol	\$1.07 per wine gallon
“Still wines” more than 14 percent, but not more than 21 percent, alcohol.	\$1.57 per wine gallon
“Still wines” more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
“Still wines” more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

⁴⁵⁷ Members of the controlled group may include foreign corporations.

⁴⁵⁸ A “still wine” is a non-sparkling wine. Most common table wines are still wines.

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Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced Rates and Exemptions for Certain Wine Producers

Wineries having aggregate annual production not exceeding 250,000 gallons (“small domestic producers”) receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.⁴⁵⁹ The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term “controlled group” has the meaning assigned to it by IRC section 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single adult households.

New Federal Law (IRC section 5041)

The provision modifies alcohol-by-volume levels of the first two tiers of the excise tax on wine, by changing 14 percent to 16 percent. Thus, under the provision, a wine producer or importer may produce or import “still wine” that has an alcohol-by-volume level of up to 16 percent, and remain subject to the lowest rate of \$1.07 per wine gallon.

Effective Dates

The provision applies to wine removed after December 31, 2017, and does not apply to wine removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

⁴⁵⁹ IRC section 5041(c).

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Impact on California Revenue

The FTB does not administer these types of excise taxes.

<u>Section</u>	<u>Section Title</u>
13806	Definition of Mead and Low Alcohol by Volume Wine

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (IRC section 5041)	
“Still wines” ⁴⁶⁰ not more than 14 percent alcohol	\$1.07 per wine gallon
“Still wines” more than 14 percent, but not more than 21 percent, alcohol.	\$1.57 per wine gallon
“Still wines” more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
“Still wines” more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced Rates and Exemptions for Certain Wine Producers

Wineries having aggregate annual production not exceeding 250,000 gallons (“small domestic producers”) receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically

⁴⁶⁰ A “still wine” is a non-sparkling wine. Most common table wines are still wines.

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produced and removed during a calendar year.⁴⁶¹ The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term “controlled group” has the meaning assigned to it by IRC section 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single adult households.

New Federal Law (IRC section 5041)

The provision designates mead and certain sparkling wines to be taxed at the lowest rate applicable to “still wine,” of \$1.07 per wine gallon of wine. Mead is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,⁴⁶² which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5 percent alcohol-by-volume. The sparkling wines eligible to be taxed at the lowest rate are those wines that contain not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,⁴⁶³ which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape, and which contain less than 8.5 percent alcohol by volume.

Effective Dates

The provision applies to wine removed after December 31, 2017, and does not apply to wine removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

⁴⁶¹ IRC section 5041(c).

⁴⁶² The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

⁴⁶³ The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

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<u>Section</u>	<u>Section Title</u>
13807	Reduced Rate of Excise Tax on Certain Distilled Spirits

Background

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.⁴⁶⁴ The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.⁴⁶⁵

Distilled spirits are taxed at a rate of \$13.50 per proof gallon.⁴⁶⁶ Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into⁴⁶⁷ the United States (less certain administrative costs) is transferred (“covered over”) to Puerto Rico and the U.S. Virgin Islands.⁴⁶⁸ The amount covered over is \$10.50 per proof gallon (\$13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016). Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.⁴⁶⁹

New Federal Law (IRC section 5001)

The provision institutes a tiered rate for distilled spirits. The rate of tax is lowered to \$2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits, \$13.34 for all proof gallons in excess of that amount but below 22,130,000 proof gallons, and \$13.50 for amounts thereafter. The provision contains rules so as to prevent members of the same controlled group from receiving the lower rate on more than 100,000 proof gallons of distilled spirits. Importers of distilled spirits are eligible for the lower rates.

⁴⁶⁴ IRC section 5001.

⁴⁶⁵ IRC sections 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.

⁴⁶⁶ A “proof gallon” is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. IRC section 5010.

⁴⁶⁷ Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are “brought into” rather than “imported into” the U.S.

⁴⁶⁸ IRC section 7652.

⁴⁶⁹ IRC section 5011. IRC section 5011 is administered and enforced by the IRS.

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Effective Dates

The provision applies to distilled spirits removed after December 31, 2017, and does not apply to distilled spirits removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

<u>Section</u>	<u>Section Title</u>
13808	Bulk Distilled Spirits

Background

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.⁴⁷⁰ The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.⁴⁷¹

Distilled spirits are taxed at a rate of \$13.50 per proof gallon.⁴⁷² Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Additionally, in order to transfer such spirits in bond without payment of tax, such spirits may not be transferred in containers smaller than one gallon.⁴⁷³ Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

⁴⁷⁰ IRC section 5001.

⁴⁷¹ IRC Sections 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.

⁴⁷² A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. IRC section 5010.

⁴⁷³ IRC section 5212.

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A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into⁴⁷⁴ the United States (less certain administrative costs) is transferred (“covered over”) to Puerto Rico and the U.S. Virgin Islands.⁴⁷⁵ The amount covered over is \$10.50 per proof gallon (\$13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.⁴⁷⁶

New Federal Law (IRC section 5212)

The provision allows distillers to transfer spirits in approved containers other than bulk containers in bond without payment of tax.

Effective Dates

The provision applies to distilled spirits transferred in bond after December 31, 2017, and does not apply to distilled spirits transferred in bond after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

⁴⁷⁴ Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are “brought into” rather than “imported into” the U.S.

⁴⁷⁵ IRC section 7652.

⁴⁷⁶ IRC section 5011. IRC section 5011 is administered and enforced by the IRS.

Subpart B—Miscellaneous Provisions

<u>Section</u>	<u>Section Title</u>
13821	Modification of Tax Treatment of Alaska Native Corporations and Settlement Trusts

Background

The Alaska Native Claims Settlement Act (ANCSA)⁴⁷⁷ established Native Corporations⁴⁷⁸ to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of ANCSA, unless a Native Corporation specifically allows other shareholders under specified procedures.

ANCSA permits a Native Corporation to transfer money or other property to an Alaska Native Settlement Trust (Settlement Trust) for the benefit of beneficiaries who constitute all or a class of the shareholders of the Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.⁴⁷⁹

Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special tax rules enacted in 2001 allow an election to use a more favorable tax regime for transfers of property by a Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust. There is also simplified reporting to beneficiaries.

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals, (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from a Native Corporation to an electing Settlement Trust generally will not result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from State and local bonds for the same period. Amounts distributed in excess of the

⁴⁷⁷ 43 U.S.C. 1601 *et seq.*

⁴⁷⁸ Defined at 43 U.S.C. 1602(m).

⁴⁷⁹ With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

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amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Native Corporation. Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Native Corporation. This rule prevents a stockholder from being able to take advantage of a decrease in value of a Native Corporation that is caused by a transfer of assets from the Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under IRC section 6034A.

The election to pay tax at the lowest rate is not available in certain disqualifying cases where transfer restrictions have been modified to allow a transfer of either: (a) a beneficial interest that would not be permitted by section 7(h) of the ANCSA if the interest were Settlement common stock, or (b) any stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement common stock and the Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying transfers, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax rate bracket.

New Federal Law (IRC sections 139G, 247, 6039H)

The provision comprises three separate but related sections. The first section allows a Native Corporation to assign certain payments described in ANCSA to a Settlement Trust without having to recognize gross income from those payments, provided the assignment is in writing and the Native Corporation has not received the payment prior to assignment. The Settlement Trust is required to include the assigned payment in gross income when received.

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The second section allows a Native Corporation to elect annually to deduct contributions made to a Settlement Trust. If the contribution is in cash, the deduction is in the amount of cash contributed. If the contribution is property other than cash, the deduction is the amount of the Native Corporation's basis in the contributed property (or the fair market value of such property, if less than the Native Corporation's basis), and no gain or loss can be recognized on the contribution. The Native Corporation's deduction is limited to the amount of its taxable income for that year, and any unused deduction may be carried forward 15 additional years. The Native Corporation's earnings and profits for the taxable year are reduced by the amount of any deduction claimed for that year.

Generally, the Settlement Trust must include income equal to the deduction by the Native Corporation. For contributions of property other than cash, the Settlement Trust takes a basis in the property equal to its basis in the hands of the Native Corporation immediately before the contribution (or the fair market value of such property, if less than the Native Corporation's basis), and may elect to defer recognition of income associated with such property until the Settlement Trust sells or disposes of the property. In that case, any income that is deferred (i.e., the amount of income that would have been included upon contribution absent the election to defer) is treated as ordinary income, while any gain in excess of the amount that is deferred takes the same character as if the election had not been made. If property subject to this election is disposed of within the first taxable year subsequent to the taxable year in which the property was contributed to the Settlement Trust, the election is voided with respect to the property, and the Settlement Trust is required to pay any tax applicable to the disposition of the property, including interest, as well as a penalty of 10 percent of the amount of the tax. The provision provides for a four year assessment period in which to assess the tax, interest, and penalty amounts. The provision permits the amendment of the terms of any Settlement Trust agreement to allow this election within one year of the enactment of the provision, with certain restrictions.

The third section of the provision requires any Native Corporation which has made an election to deduct contributions to a Settlement Trust as described above to furnish a statement to the Settlement Trust containing: (1) the total amount of contributions; (2) whether such contribution was in cash; (3) for non-cash contributions, the date that such property was acquired by the Native Corporation and the adjusted basis of such property on the contribution date; (4) the date on which each contribution was made to the Settlement Trust; and (5) such information as the Secretary determines is necessary for the accurate reporting of income relating to such contributions.

Effective Dates

The provision relating to the exclusion for ANCSA payments assigned to Settlement Trusts is effective to taxable years beginning after December 31, 2016.

The provision relating to the deduction of contributions is effective for taxable years for which the Native Corporation's refund statute of limitations period has not expired, and the provision provides a one-year waiver of the refund statute of limitations period in the event that the limitation period expires before the end of the one-year period beginning on the date of enactment, December 22, 2017.

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The provision relating to the reporting requirement applies to taxable years beginning after December 31, 2016.

California Law (R&TC sections 18631)

California does not conform to the modification of tax treatment of Alaska Native Corporations and Settlement Trusts under IRC sections 139G and 247, and has no similar provision.

California law provides, under the AFITL,⁴⁸⁰ that the FTB may require a copy of any information return required to be filed with the Secretary of the Treasury under IRC section 6039H, relating to the requirement that any Native Corporation which has made an election to deduct contributions to a Settlement Trust to furnish a statement to the Settlement Trust, at the time and in the form and manner as the FTB may, by forms and instructions, require.

Impact on California Revenue

Not applicable.

<u>Section</u>	<u>Section Title</u>
13822	Amounts Paid for Aircraft Management Services

Background

Excise Tax on Taxable Transportation by Air

For domestic passenger transportation, IRC section 4261 imposes an excise tax on amounts paid for taxable transportation. In general, for domestic flights, the tax consists of two parts: a 7.5 percent *ad valorem* tax applied to the amount paid and a flat dollar amount for each flight segment (consisting of one takeoff and one landing). “Taxable transportation” generally means transportation by air which begins and ends in the United States. The tax is paid by the person making the payment subject to tax and the tax is collected by the person receiving the payment. For commercial freight aviation, the *ad valorem* tax is 6.25 percent of the amount paid for transportation.

In determining whether a flight constitutes taxable transportation and whether the amounts paid for such transportation are subject to tax, the IRS has looked at who has “possession, command, and control” of the aircraft based on the relevant facts and circumstances.⁴⁸¹

⁴⁸⁰ R&TC section 18631(c)(25).

⁴⁸¹ See, e.g., Revenue Ruling 60-311, 1960-2 C.B. 341, which held that, since the company in question retains the elements of possession, command, and control of the aircraft and performs all services in connection with the operation of the aircraft, the company is, in fact, furnishing taxable transportation to the lessee; and the tax on the

Applicability to Aircraft Management Services

Generally, an aircraft management services company (management company) has as its business purpose the management of aircraft owned by other corporations or individuals (aircraft owners). In this function, management companies provide aircraft owners, among other things, with administrative and support services (such as scheduling, flight planning, and weather forecasting), aircraft maintenance services, the provision of pilots and crew, and compliance with regulatory standards. Although the arrangement between management companies and aircraft owners may vary, it is our understanding that aircraft owners generally pay management companies a monthly fee to cover the fixed expenses of maintaining the aircraft (such as insurance, maintenance, and recordkeeping) and a variable fee to cover the cost of using the aircraft (such as the provision of pilots, crew, and fuel).

In March 2012, the IRS issued a Chief Counsel Advice determining that a management company provided all of the essential elements necessary for providing transportation by air and the owner relinquished possession, command and control to the management company.⁴⁸² Thus, the management company was determined to be providing taxable transportation to the owner and was required to collect the appropriate federal excise tax from the aircraft owner and remit it to the IRS. The Chief Counsel Advice resulted in increased audit activity by the IRS on aircraft management companies.

In May 2013, the IRS suspended assessment of the federal excise tax with respect to aircraft management services while it developed guidance on the tax treatment of aircraft management issues. In a 2015 opinion,⁴⁸³ an Ohio district court held that the existing revenue rulings (in effect for the tax period April 1, 2005, through June 30, 2009, the period that was the subject of the litigation) regarding the possession, command and control test, failed to provide precise and not speculative notice of a collection obligation as it related to whole-aircraft management contracts.⁴⁸⁴ As a result, the court ruled as a matter of law that because precise and not speculative notice was not received, the aircraft management company plaintiff did not have a collection obligation with respect to the Federal excise tax on payments received for whole-aircraft management services.

transportation of persons applies to the portion of the total payment which is allocable to the transportation of persons, provided such allocation is made on a fair and reasonable basis. If no allocation is made, the tax applies to the total payment for the lease of the aircraft.

⁴⁸² CCA 2012-10026 (March, 2012).

⁴⁸³ *Netjets Large Aircraft Inc. v. United States*, 116 A.F.T.R. 2d. 2015-6776 (S.D. Ohio, 2015).

⁴⁸⁴ The district court held that such notice is required to persons having a deputy tax collection obligation under the rationale of the Supreme Court's holding in *Central Illinois Public Service Company v. United States*, 435 U.S. 21 (1978).

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In 2017, the IRS decided not to pursue examination of the issue of whether amounts paid to aircraft companies by the owners or lessors of the aircraft are taxable until further guidance is made available. According to the IRS, for any exam in suspense the aircraft management fee issue was conceded and the taxpayers were notified accordingly.⁴⁸⁵ The IRS has not issued further guidance on this issue.

New Federal Law (IRC section 4261)

The Senate amendment exempts certain payments related to the management of private aircraft from the excise taxes imposed on taxable transportation by air. Exempt payments are those amounts paid by an aircraft owner for management services related to maintenance and support of the owner's aircraft or flights on the owner's aircraft. Applicable services include support activities related to the aircraft itself, such as its storage, maintenance, and fueling, and those related to its operation, such as the hiring and training of pilots and crew, as well as administrative services such as scheduling, flight planning, weather forecasting, obtaining insurance, and establishing and complying with safety standards. Aircraft management services also include such other services as are necessary to support flights operated by an aircraft owner.

Payments for flight services are exempt only to the extent that they are attributable to flights on an aircraft owner's own aircraft.⁴⁸⁶ Thus, if an aircraft owner makes a payment to a management company for the provision of a pilot and the pilot provides his services on the aircraft owner's aircraft, such payment is not subject to Federal excise tax. However, if the pilot provides his services to the aircraft owner on an aircraft other than the aircraft owner's (for instance, on an aircraft that is part of a fleet of aircraft available for third-party charter services), then such payment is subject to Federal excise tax.

The provision provides a pro rata allocation rule in the event that a monthly payment made to a management company is allocated in part to exempt services and flights on the aircraft owner's aircraft, and in part to flights on aircraft other than the aircraft owner's. In such a circumstance, Federal excise tax must be collected on that portion of the payment attributable to flights on aircraft not owned by the aircraft owner.

⁴⁸⁵ See also, Kerry Lynch, *IRS To Shelve Pending Audits on Aircraft Management Fees*, AINonline (July 17, 2017) <http://www.ainonline.com/aviation-news/business-aviation/2017-07-17/irs-shelve-pending-audits-aircraft-management-fees>.

⁴⁸⁶ Examples of arrangements that cannot qualify a person as an "aircraft owner" include ownership of stock in a commercial airline and participation in a fractional ownership aircraft program. Ownership of stock in a commercial airline cannot qualify an individual as an "aircraft owner" of a commercial airline's aircraft, and amounts paid for transportation on such flights remain subject to the tax under IRC section 4261. Similarly, participation in a fractional ownership aircraft program does not constitute "aircraft ownership" for purposes of this standard. Amounts paid to a fractional ownership aircraft program for transportation under such a program are exempt from the ticket tax under IRC section 4261(j) if the aircraft is operating under subpart K of part 91 of title 14 of the Code of Federal Regulations ("subpart K"), and flights under such program are subject to both the fuel tax levied on non-commercial aviation an additional fuel surtax under IRC section 4043 of the Code. A business arrangement seeking to circumvent that surtax by operating outside of subpart K, allowing an aircraft owner the right to use any of a fleet of aircraft, be it through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other arrangement that does not reflect true tax ownership of the aircraft being flown upon, is not considered ownership for purposes of the provision.

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Under the provision, a lessee of an aircraft is considered an aircraft owner provided that the lease is not a “disqualified lease.” A disqualified lease is any lease of an aircraft from a management company (or a related party) for a term of 31 days or less.

Effective Dates

The provision is effective for amounts paid after the date of enactment, December 22, 2017.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

<u>Section</u>	<u>Section Title</u>
13823	Opportunity Zones

Background

The IRC occasionally has provided several incentives aimed at encouraging economic growth and investment in distressed communities by providing federal tax benefits to businesses located within designated boundaries.⁴⁸⁷

One of these incentives is a federal income tax credit that is allowed in the aggregate amount of 39 percent of a taxpayer investment in a qualified community development entity (CDE).⁴⁸⁸ In general, the credit is allowed to a taxpayer who makes a “qualified equity investment” in a CDE which further invests in a “qualified active low-income community business.” CDEs are required to make investments in low income communities (generally communities with 20 percent or greater poverty rate or median family income less than 80 percent of statewide median). The credit is

⁴⁸⁷ Such designated areas were referred to as empowerment zones, the District of Columbia Enterprise (“DC”) Zone, and the Gulf Opportunity (“GO”) Zone, and each of these designations and attendant tax incentives have expired. The designations and tax incentives for the DC Zone, and the GO Zone generally expired after December 31, 2011. IRC sections 1400(f), 1400N(h), 1400N(c)(5), 1400N(a)(2)(D), 1400N(a)(7)(C), 1400N(d). The empowerment zones program and attendant tax incentives expired as of December 31, 2016. IRC section 1391(d)(1). There are also areas that were designated as renewal communities under IRC section 1400E which received tax benefits that all expired as of December 31, 2009, except that a zero-percent capital gains rate applies with respect to gain from the sale through December 31, 2014, of a qualified community asset acquired after December 31, 2001, and before January 1, 2010 and held for more than five years. For more information on these programs and attendant tax incentives, see Joint Committee on Taxation, *Incentives for Distressed Communities: Empowerment Zones and Renewal Communities* (JCX- 38-09), October 5, 2009.

⁴⁸⁸ IRC section 45D.

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allowed over seven years, five percent in each of the first three years and six percent in each of the next four years. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed. The Department of Treasury's Community Development Financial Institutions Fund (CDFI) allocates the new markets tax credits.

The maximum annual amount of qualified equity investments is \$3.5 billion for calendar years 2010 through 2019. The new markets tax credit is set to expire on December 31, 2019. No amount of unused allocation limitation may be carried to any calendar year after 2024.

New Federal Law (IRC sections 1400Z-1 and 1400Z-2)

The provision provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in the qualified opportunity fund.

The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in IRC section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

Governors may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts; otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations.

The provision provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The provision intends that the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit. The provision provides the Secretary authority to carry out the process.

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If a qualified opportunity fund fails to meet the 90 percent requirement and unless the fund establishes reasonable cause, the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets, over the aggregate amount of qualified opportunity zone property held by the fund multiplied by the underpayment rate in the IRC. If the fund is a partnership, the penalty is taken into account proportionately as part of each partner's distributive share.

Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property. The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the provision.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

The Secretary or the Secretary's delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level. To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund

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investments. The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.

Effective Dates

The provision is effective on the date of enactment, December 22, 2017.

California Law (R&TC sections 17053.73 and 23626)

California does not conform to the deferral and exclusion of capital gains reinvested or invested in qualified opportunity zone funds under IRC sections 1400Z-1 and 1400Z-2, and has no similar provisions.

California has a tax incentive provision, under the PITL and the CTL, for taxpayers conducting business activities in designated census tracts or economic development areas. The New Employment Credit⁴⁸⁹ is available for each taxable year beginning on or after January 1, 2014, and before January 1, 2021, to qualified taxpayers that hire qualified full-time employees on or after January 1, 2014, and pay or incur qualified wages attributable to work performed by the qualified full-time employee in a designated census tract or economic development area.

Impact on California Revenue

Not applicable.

⁴⁸⁹ R&TC section 17053.73.

EXHIBIT A – 2017 MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING A CALIFORNIA RESPONSE

1. Public Law 115-65, Disaster Tax Relief and Airport and Airway Extension Act of 2017.

IRC Section	Public Law No.	Act Section No.	131 Stat. Page
1	115-63	1(a)	1168
4081	115-63	202 (a)	1171
4083	115-63	202 (c)(1)	1171
4261	115-63	202 (b)(1)	1171
4261	115-63	202 (c)(2)	1171
4271	115-63	202 (b)(2)	1171
9502	115-63	201	1171